



INDUSTRY
COMMISSION

COMPETITIVE TENDERING AND CONTRACTING BY PUBLIC SECTOR AGENCIES

OVERVIEW

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24 January 1996

The Honourable George Gear MP
Assistant Treasurer
Parliament House
CANBERRA ACT 2600

Dear Minister

In accordance with Section 7 of the *Industry Commission ACT 1989*, we have pleasure in submitting to you the report on Competitive Tendering and Contracting by Public Sector Agencies.

Yours sincerely

Keith J Horton-Stephens
Presiding Commissioner

Colin McAlister
Associate Commissioner

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ABBREVIATIONS

A&E	Access and Equity
ABC	Activity Based Costing
ABS	Australian Bureau of Statistics
ACHS	Australian Council of Healthcare Standards
ACTU	Australian Council of Trade Unions
AERCF	Australian Earthmovers' and Road Contractors' Federation
ALRC	Australian Law Reform Commission
ANAO	Australian National Audit Office
APS	Australian Public Service
ARC	Administrative Review Council
AusAID	Australian Agency for International Development
AS	Australian Standard series (for example AS 9000)
BIE	Bureau of Industry Economics
CCM	Contracted Case Manager
CEO	Chief Executive Officer
CCT	Compulsory Competitive Tendering
CES	Commonwealth Employment Service
COAG	Council of Australian Governments
CSD	Competitive Service Delivery (in Queensland Government)
CSP	Commercial Support Program (in Department of Defence)
CTC	Competitive Tendering and Contracting
CUA	Common Use Arrangement
DAS	Commonwealth Department of Administrative Services
DVA	Commonwealth Department of Veterans' Affairs
ECC	Ethnic Communities Council, New South Wales
EEO	Equal Employment Opportunity
EOI	Expression of Interest
ESRA	Commonwealth Employment Services Regulatory Authority
FoI	Freedom of Information
GTE	Government Trading Enterprise
HREOC	Commonwealth Human Rights and Equal Opportunity Commission
ICAC	Independent Commission Against Corruption, New South Wales
IHO	In-house Option
IIS	Industry Impact Statement
ISO	International Organisation for Standardisation

IT	Information Technology
ITR	Invitation To Register Interest
MAB	Commonwealth Government Management Advisory Board
MAV	Municipal Association of Victoria
MBO	Management Buyout
MIAC	Commonwealth Government Management Improvement Advisory Committee
NAC	Net Avoidable Cost
NESB	Non-English Speaking Background
OECD	Organisation for Economic Co-operation and Development
PSRC	Public Sector Research Centre, University of New South Wales
QA	Quality Assurance
QBS	Qualification Based Selection
RFP	Request for Proposal
RFT	Request for Tender
RGH	Repatriation General Hospital
SME	Small to Medium Sized Enterprise
SOR	Statement of Requirement

GLOSSARY

Bundling of services	Grouping together a number of complementary services into one tender.
Clean break strategy	Where the agency does not negotiate or arrange employment conditions of service for staff affected by CTC with the new external supplier. Staff involved in the contracted out function are considered to be excess and subject to the relevant redeployment and redundancy arrangements. However, employees may be free to seek employment with the successful bidder.
Competitive neutrality	Where firms compete on their inherent strengths and weaknesses irrespective of ownership.
Competitive tendering	The process of selecting a preferred supplier from a range of potential contractors by seeking offers (tenders) and evaluating these on the basis of one or more selection criteria.
Compulsory Competitive Tendering (CCT)	Where agencies are required to introduce competitive tendering to specified services or a specified level of expenditure.
Contestability	The degree of ease with which firms can enter or leave a market reflecting the level of potential competition. In a contestable market the threat of new entrants causes the incumbent firms to operate at levels approaching that expected in a competitive market.
Contracting out	An arrangement whereby a contracting agency enters into a contract with a supplier from outside that agency for the provision of goods and/or services which typically have previously been provided internally — not necessarily involving competitive bids. Also called ‘outsourcing’.
Core activities	Activities which are held to be central to an agency’s function.

Corporatisation	The process separating a GTE from the day-to-day control of government. This aims to replicate the commercial incentives and sanctions which apply to private firms. The GTE is either constituted as a government owned enterprise under the Corporations law as a limited liability company or as a statutory authority under its own legislation.
Cost shifting	This occurs when the responsibility of meeting certain costs may be shifted between the agency and the external bidder or between one level of government to another.
Double dipping	Where employees have a guaranteed job with the new supplier and also have access to a voluntary redundancy payment.
Economies of scale	Factors which cause the average cost of producing a commodity or service to fall as the firm increases the scale of production.
Economies of scope	Factors which make it cheaper to produce a range of related products together rather than to make each of the individual products separately.
Effectiveness	When objectives or goals are successfully achieved.
Efficiency	When a particular result is achieved with the least resources or inputs.
Industry impact statement	A statement which identifies potential industry development opportunities to be addressed by prospective contractors in their bids.
In-house bid	A tender prepared and submitted by internal agency staff and where if successful, internal staff provide the specified service on a 'contractual' basis.
Invitation to register an interest (ITR)	The first stage in a tendering process where prospective tenderers are invited by the contracting agency to register their intention of tendering for the delivery of the service.

Loss leading	The practice of pricing below short-term marginal cost, with the intention of recouping short-term losses through increased market share and prices in the longer term.
Management buy out (MBO)	When employees of an organisation pool their resources and bid to purchase and perform a specific function. If successful, the employees resign and perform the work as a private entity.
Management costs	The costs of managing internal transactions in an organisation.
Market testing	The practice of comparing the internal costs of service delivery (or the in-house bid price) against the costs of externally-sourced service delivery.
Monitoring costs	The costs of overseeing and evaluating transactions, whether internal to the organisation or in external contracts.
Multi-stage tendering	The process of selecting a preferred service provider using a number of individual tender stages, such as short-listing or prequalification prior to the final tender. See also Request for proposal and Invitation to register an interest.
Natural monopoly	A market where a single supplier is able to supply the required service at a lower cost than any combination of two or more suppliers.
Negotiated transfer approach	Where an agency negotiates arrangements for the transfer of staff to the new supplier including in some cases, the number of staff to be transferred and their pay and conditions.
Outsourcing	See Contracting out.
Partnering	see Strategic alliance.
Performance indicators	Quantitative and qualitative statistical information used to assess how successfully objectives are being achieved.
Purchaser/provider split	The organisational separation of the roles of the purchaser of services and the provider.

Qualification Based Selection (QBS)	A supplier selection mechanism which selects the preferred contractor on the basis of qualifications or experience, before negotiating other contract/service details.
Quality accreditation	One form of quality assurance where the setting of service standards, the process for review against these standards and the results of the review are formalised through an accreditation body. This body is normally independent of government although often funded by it.
Quality certification	Where organisations develop and implement a quality management system and audit the system against appropriate standards developed externally. For instance, the AS 9000 series of standards is a common quality management standard frequently sought by organisations in Australia.
Request for Proposal (RFP)	A document seeking information and opinions from prospective tenderers as to costs and methods of providing the service. It may be used to shortlist contenders in a multi-stage tendering process.
Request for Tender (RFT)	An invitation to submit tenders addressing the full range of criteria and conditions listed in the tender documentation.
Statement of Requirement (SOR)	A document describing in broad terms the nature of the service required by the contracting agency. It is focussed on outcomes rather than processes, and may deal with price, performance standards, performance evaluation mechanisms, and other service delivery concerns.
Strategic alliance	An agency-contractor relationship where each party acts in a manner consistent with the other's interests, beyond that required by a formal contract. Also called 'partnering'.

Transaction costs

The costs associated with the process of buying and selling to external organisations. For instance, costs incurred in conducting a tendering process and specifying contracts.

Transition costs

One-off costs incurred in the change from internal provision to contracting. They may include redundancy payments and the costs of selling surplus equipment.

TERMS OF REFERENCE

I, GEORGE GEAR, Assistant Treasurer, under Part 2 of the *Industry Commission Act 1989*:

1. refer contracting out by public sector agencies for inquiry and report by the Industry Commission within twelve months of receiving this reference: in this reference 'contracting out' refers to an arrangement whereby a government body enters into a contract with an external or government supplier for the provision of goods and/or services;
2. specify that in making its recommendations the Commission aim to improve the overall performance of the Australian economy;
3. request that the Commission report on:
 - (a) the nature, extent and scope of contracting out by Commonwealth, State and Local Governments and their agencies;
 - (b) the costs and benefits of contracting out, taking into account factors such as the impact on Government bodies with respect to value for money, quality of service and accountability, and the existing legal framework;
 - (c) the impact of contracting out on the ability of funding agencies to maintain an informed and responsive view of changes in the nature and structure of demand for the services they fund;
 - (d) the implications for employees and their terms and conditions of employment arising from contracting out;
 - (e) mechanisms or processes for the provision of internal (or in house) tendering;
 - (f) the effectiveness of existing mechanisms for contracting out, including any barriers to the cost effective use of contracting out; use of benchmarking, including of quality of service indicators; and improving incentives for market testing;
 - (g) any measures which could be taken to promote the more cost effective use of contracting out, in ways that are consistent with the principles of efficient resource use in the economy;
 - (h) the identification of groups who would benefit from or be disadvantaged by any measures flowing from 3(g);

- (i) implementation strategies for those measures outlined in 3(g); and
 - (j) the development of a set of indicative principles for public sector managers to use in assessing the scope for contracting out;
4. request that the Commission consider and report on the impact of contracting out on the capacity of Governments to seek overall efficiency in urban development as distinct from efficiency solely within individual service sectors;
 5. request that, in reporting on the scope for contracting out in the health sector, the Commission take into account the Government's commitment to providing patients with public access and identify the financial flow and taxation implications where the return to a private investor in health facilities is reliant solely, or in large part, on Government contracts;
 6. without limiting the scope of this reference request that, without disclosing material provided in confidence, the Commission report on examples of past successes and failures of contracting out, by way of case studies or other means;
 7. specify that the Commission take account of any recent substantive studies undertaken elsewhere; and
 8. specify that the Commission have regard to the established economic, social, environmental, public administration and regulatory reform objectives of governments.

GEORGE GEAR

- * The Assistant Treasurer extended the reporting date to 31 January 1996.

OVERVIEW

KEY MESSAGES

The key question the Commission has addressed in this inquiry is how governments can best deliver quality services and give value for money to the community.

To do this, governments need to draw on the valuable human and capital resources which exist throughout Australia in the public, private and not-for-profit sectors.

Competitive tendering and contracting (CTC) is about helping public sector managers get best value for money by ensuring that the best provider is chosen for the task at hand.

When done well, CTC can lead to significant improvements in accountability, quality, and cost-effectiveness, providing benefits to clients, taxpayers, and the broader community.

CTC is not an end in itself. It is a valuable, but currently under-utilised, option for improving government throughout Australia. To maximise its potential, it must be applied intelligently. Some key lessons from the inquiry are:

- * It is vital to structure CTC in a way which ensures clear and accurate specifications, effective competition so that the best provider is chosen, and adequate monitoring of the contractor's performance.
- * A major benefit of CTC is that it forces agencies to review what they are doing and whether their current activities are effective in meeting underlying policy goals.
- * The focus of CTC needs to be on service outcomes, rather than inputs.
- * Successful CTC requires a cultural change in government and a new mix of skills. It has to be supported by Ministers/Councillors, driven by senior management, and handled in close consultation with staff and their representatives, as well as clients and the community at large.

The Context

There are pressures on government to perform better. Governments throughout Australia face social and economic pressure to become more effective and efficient in providing services ranging from health and community services to national defence.

Governments have responded with reforms... In response, governments have introduced a range of public sector reforms. Some seek internal improvements, others to inject competition from outside an agency.

... including CTC. Competitive tendering and contracting (CTC) has two features which distinguish it from the way many public services have traditionally been provided. First, it means clearly defining the services to be delivered. Second, it involves periodically opening their delivery to competition from external suppliers.

The inquiry is about when and how CTC can be used to get better value for money. The debate about CTC largely revolves around whether it does in fact lead to better outcomes compared with direct public provision. Key issues in the debate include the impact of CTC on accountability and quality; the extent, source and sustainability of cost savings; equity and distributional impacts of CTC; and the suitability of particular activities for contracting.

This report seeks to examine the experiences with CTC and to identify how, and in what circumstances, CTC can be used to improve the efficiency and effectiveness of government.

Trends in CTC

Contracting has been used by governments for many years... Contracting by public sector agencies for the delivery of services is not new. Some mail delivery has been contracted out since it was introduced in Australia, while local governments have contracted refuse collection and road maintenance since the turn of the century.

- ... and is now used by all levels of government in Australia.* Contracting is widely used by public sector agencies at all levels of government in Australia. While comprehensive data is not available, the value of services contracted by Australian public sector agencies is estimated to be at least \$13 billion a year.
- Its use is growing and extending to encompass new areas...* While long-term trends are hard to identify, there has been a sharp increase in the use of CTC in some jurisdictions in the 1990s. In addition, contracting has expanded from services such as refuse collection and cleaning to areas sometimes seen as 'core' government activities such as prison management, employment assistance, and hospital services.
- ... and is used widely overseas and in the private sector.* The use of CTC is common at all levels of government in other countries. Contracting is also used for many activities in a range of industries in the private sector.

Box 1: CTC: Some key facts

- The Commonwealth public sector contracts an estimated \$8 billion of services, compared with around \$3.3 billion at state government level and close to \$2 billion at local government level.
- Local governments appear to contract the greatest proportion of their current expenditure followed by Commonwealth, then state governments.
- Services most commonly contracted include cleaning, information technology, construction, maintenance and technical services.
- Most contracts at state and Commonwealth levels are won by the private sector.

The benefits and costs of CTC

There are diverse claims about the effects of CTC.

Advocates of CTC point to increased flexibility in service delivery, greater focus on outputs and outcomes rather than inputs, allowing public sector management to focus on strategic priorities, encouragement of suppliers to provide innovative solutions and cost savings in providing services. Others question the extent of these benefits, noting the costs associated with specifying, awarding and monitoring contracts, and potentially adverse effects on accountability, quality, public sector jobs, wages and conditions and social objectives.

There are different stakeholders.

Many different groups are likely to be affected by CTC. Taxpayers and ratepayers are keen to see public money being spent efficiently and equitably. Clients want high quality services. Potential contractors want fair opportunities to compete for what can be significant markets. Public sector employees and their unions want to maintain public delivery of the services. Those in rural and remote areas are concerned about the effect of outside competition on the local economy. The interests of these various groups can and often do conflict.

Accountability

Agencies remain accountable.

The Commission agrees with numerous inquiry participants that, while responsibility to do certain things can be transferred, accountability for the results cannot.

Whatever the method of service delivery, a government agency must remain accountable for the efficient performance of the functions delegated to it by government, including:

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- translating broad program objectives into detailed service specifications;
 - choosing a person (in-house or external) to deliver the service;
 - ensuring that the service required is actually delivered; and
 - dealing equitably and responsively with clients and the public.

CTC inevitably involves redefining responsibilities and relationships between key stakeholders, and introduces a new player — the contracted service provider — into the chain. Some inquiry participants argued that the introduction of this ‘new player’ can blur accountability for service delivery.

If implemented well, CTC can enhance accountability...

Others considered, as does the Commission, that CTC offers the potential to enhance accountability in a number of ways.

... primarily by clearer specification of objectives and allocation of responsibility...

First, CTC can enhance accountability by requiring the contracting agency to specify clearly the service to be delivered and to allocate precisely responsibilities between the agency and the contractor for delivery of the service. This makes it easier to identify the cause of any failure. Every effort should be made to eliminate confusion about the lines of responsibility: they should be kept as clear and as simple as possible.

... and by improving information on standards and outcomes.

Second, CTC can enhance accountability by requiring the contracting agency to specify the criteria on which the contractor’s performance is to be measured and monitored. However, it may be more difficult to do this for some services than others, particularly where the service provider must exercise discretion on the amount and mix of services to be provided to clients — for example, people with multiple disabilities.

Wherever possible, decisions must be open to public scrutiny.

There is sometimes tension between making information on contracting decisions public and protecting commercial confidentiality. While the obligation of the government to be open and accountable may legitimately give way to conflicting considerations of ‘commercial sensitivity’ in some cases (for example, where information contains valuable intellectual property), there should be a preference for disclosure.

RECOMMENDATION 1

Recognising the balance between commercial confidentiality and accountability, governments should make public as much information as possible to enable interested people to assess contracting decisions made by agencies. Of particular importance is information on the specifications of the service, the criteria for tender evaluation, the criteria for the measurement of performance and how well the service provider has performed against those criteria.

While it is important to observe people’s rights...

A third aspect of accountability is the ability of persons to seek redress where they are dissatisfied with the manner in which a service is provided (for instance, where quality is poor, or where confidential information is misused). A change from direct to contracted provision ought not undermine the ability of individuals or organisations to seek redress for decisions or actions for which governments are accountable.

... care should be taken in extending public sector mechanisms.

The suggestion by some participants that administrative law be extended to contractors raises many complex issues. Any consideration of that idea should include all the potential costs and benefits, taking into account the full range of mechanisms for redress which affect accountability where government services are contracted.

Accountability can be enhanced by greater responsiveness to clients...

CTC can be introduced in a way which enhances the capacity to achieve redress where there are a number of providers between whom purchasers and clients (where different) may choose. Already, for example, clients can choose between alternative case managers contracted to the Employment Services Regulatory Authority (ESRA). Redress may also be enhanced by making customer satisfaction part of performance standards.

... and privacy can be protected.

When circumstances indicate that particular privacy protection is needed, the inclusion of privacy clauses in contracts seems to be an effective approach.

Quality

Governments want value for money.

Governments are rightly concerned with effectiveness and value for money, which encompasses quality as well as cost. The goal of getting best value for money, not minimising cost, should underpin the CTC process.

Quality is critical.

CTC does not, of itself, bring about reductions in service quality. Agencies can do much to ensure that quality services are delivered by specifying quality objectives and monitoring the performance of contractors.

It is more difficult to specify for certain services...

In some cases, agencies may encounter difficulties in specifying and measuring quality, particularly when the future needs of individual clients cannot be predicted (for example, with aged care, disability services and emergency services). Specifying and monitoring quality may also be harder where it depends on combining a number of elements of a service in different ways for different people (for example, with prisoner management).

... but this is true whoever delivers the service.

However, the Commission is not persuaded that these difficulties are necessarily exacerbated by CTC. Nor are they necessarily overcome by agencies delivering services themselves.

CTC can foster improvements in quality...

There are many examples of where CTC has led to an improvement in quality, although there are also cases where quality has declined (see box 2).

Box 2: The impact of CTC on quality

Inquiry participants stated that, in many cases, CTC had improved the quality of services. However, examples were also given of a decline in service quality.

Reported improvements in quality

<i>Agency</i>	<i>Reported result</i>
Department of Social Security	Greater flexibility and choice in service providers and increased control of outcomes through access to the expertise of quality service providers.
Melbourne Water	A fall in the time to repair burst water and sewerage mains.
NSW Government QStores	Improvement in order delivery times from an average of 8 weeks to less than two days in the metropolitan area.
Sydney Water	A reduction in the meter reading cycle from 1 year to 8 weeks, in meter replacement times from 21 to 7 days and in emergency call out response times by more than half.
Victorian State Supply	Lead times reduced from 1-8 weeks to a reliable next day delivery even in periods of fluctuating demand.

Reported reductions in quality

<i>Agency</i>	<i>Reported result</i>
Commonwealth Attorney General's Department	The LOIS IT system contract was terminated after the contractor failed to deliver.
Keilor City Council (Vic)	Kindergarten cleaning service levels were seen to be inconsistent with specifications.
Melbourne City Council	Quality suffered as a result of the contractor not having the requisite equipment for road verge and median strip mowing.
King George V Hospital (NSW)	Cleaning service contract terminated after failure to meet desired service level.
Sutherland Shire Council (NSW)	Garbage collection contract terminated after inconsistent performance of contractor.

... and enhance client focus.

In many cases, CTC has led to a greater focus on the needs of the client. For example, the contracting of hospital services for veterans has led to an improvement in client focus (see box 3).

Box 3: The Contracting of Hospital Services for Veterans

Hollywood Hospital in Western Australia was a teaching hospital, treating veterans as well as some public patients. In February 1994, the Ramsay Health Care Group bought the hospital and entered into a 10-year contract with the Repatriation Commission for the treatment of veterans.

The Repatriation Commission and the Department of Veterans' Affairs (DVA) established a number of quality control and performance measures to ensure quality outcomes, for example:

- giving preference to external accreditation to facilitate benchmarking and performance measurement;
- analysing case-mix information to help in measuring performance and establishing benchmarks on patient care; and
- using Treatment Monitoring Committees as a forum for discussing concerns about health care.

Veterans may choose either to attend Hollywood or to be treated as a private patient in a public hospital, or in a non-contracted hospital (under certain circumstances). This places the onus on Ramsay to retain their custom.

DVA has identified, as a result of these changes, that there are now shorter waiting times for elective surgery as a result of improvements in theatre use, monitoring committees have received fewer complaints, and surveys of Hollywood patients suggest that services are as good or better than when DVA operated the hospital.

Lessons

The quality of services provided to veterans has been maintained or improved. Veterans have a greater choice of hospitals. This improves access to services for clients, and places pressure on providers to perform.

Quality problems can arise if CTC is poorly implemented...

The contracting agency's approach to the tendering process is crucial. Unplanned reductions in quality can often be attributed to a failure in the tendering process — for example, through inadequate specification of the service, inappropriate contractor selection and poor contract management. Many of the improvements in quality appear to derive from better specification of the service by the purchaser, improvements in monitoring and the ability to use external expertise.

...but experience shows these can be overcome.

It has been argued that process-related failure is endemic to CTC and successes are fortuitous. The Commission considers that experience across Australia (for example, with cleaning and refuse collection, as well as with more complex services such as hospital services for veterans and aged care) indicates that success results from good application of proper process and this can be consistently achieved.

Agencies need to ensure contractors deliver quality ... in a cost-effective manner.

Effective monitoring of contractors' performance is a key element in successful CTC. Contracting agencies need to determine the most cost-effective approach to quality assurance and performance monitoring. The higher the risk or cost associated with contract failure, the more appropriate it becomes for the contracting agency to introduce more costly techniques. Nevertheless, excessive monitoring will reduce the benefits associated with improved efficiency and innovation.

RECOMMENDATION 2

Agencies should ensure that successful tenderers have in place appropriate quality assurance systems. The systems chosen should be kept as simple and inexpensive as possible. Quality accreditation and quality systems certification should be required only where the risk and cost of quality failure is high. In other cases, a good performance record and/or evidence of appropriate internal management systems will be appropriate.

Costs

There is a keen debate about cost savings under CTC...

Much of the debate on the merits of CTC has focussed on its cost-effectiveness and its impact on efficiency. Key issues are whether CTC can provide cost savings; whether such savings have been measured properly; whether savings are maintained in the long term; and the extent to which savings represent efficiency gains or simply transfers from one group to another.

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- ... partly reflecting the difficulty in comparing all relevant costs.* There has been criticism of published studies of the cost savings available from CTC for failing to include or measure accurately all relevant costs, particularly the costs of developing and managing contracts. The cost of internal provision may also have been underestimated in these studies. To determine the cost impacts, all the costs of CTC at both the time of tender evaluation and contract completion should be compared with all the costs of internal provision.
- But the evidence suggests that CTC generally reduces costs...* While there are instances where costs have increased through its use, CTC can and generally does reduce the ongoing costs of agencies' service provision. Seventy-five per cent of surveyed Australian and overseas empirical studies found that CTC reduced the ongoing costs of service provision: savings ranged from 10 to 30 per cent in over half of the services studied. The savings from CTC can vary widely and do not appear to be strongly related to the type of service considered. Box 4 provides examples from all three levels of government.
- ... even where contract management costs are included...* There is limited evidence on the magnitude of the costs associated with transition, contract management and internal management. However, what is known of these costs indicates that, in most cases, there would still be net savings from CTC. For example, a survey of Commonwealth budget sector agencies undertaken for this inquiry found average savings of 16 per cent from CTC where contract management costs could be included.
- ... whether an in-house or external bid wins...* The savings appear to be significant regardless of whether an in-house or external bid wins. For example, the contract for maintenance of F-111 aircraft at Amberley RAAF Base was won by an in-house team. A Commission case study concludes that the in-house team has made substantial savings — annual personnel costs decreased from \$20 million to \$10.5 million and, after transition and tendering costs are included, there are annual cost savings of about \$8 million.
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Box 4: The impact of CTC on costs

There are many cases where agencies have estimated that CTC has resulted in considerable cost savings across a range of services, although there are also some examples of cost increases. Examples reported to the inquiry include:

Commonwealth Government

- the Department of Defence estimated annual total savings of \$52 million or 36 per cent of previous costs on activities contracted out under the Commercial Support Program. Total savings, including tenders won by in-house bids, totalled \$102 million or 33 per cent of previous costs;
- the Department of Employment, Education and Training reported that unit costs for its English as a Second Language courses fell 27 per cent;
- the Department of Administrative Services reported 30 per cent cost savings on its DASFLEET car breakdown service; and
- the Department of Environment, Sport and Territories stated that the cost of using information technology contractors has been at least twice the in-house cost.

State Governments

- Sydney Water reported that the cost of meter reading fell 70 per cent, from \$2.80 per meter to 77 cents;
- the Victorian Government reported average savings of 25 per cent of the previous costs of provision with savings ranging from 9 per cent to 68 per cent across departments;
- the Queensland Corrective Services Commission's comparison of the costs between the privately-operated Borallon and publicly-operated Lotus Glen prisons showed that yearly costs per prisoner were 15, 7 and 9 per cent lower in Borallon in the years 1992–93, 1993–94 and 1994–95 respectively;
- the Western Australian survey of contracting out in public sector agencies in 1995 found that cost changes ranged from an increase of 36 per cent to a decrease of 55 per cent. On average costs fell by 21 per cent;
- the South Australian Housing Trust reported savings of 58 per cent per receipt in its payment agency; and
- the Tasmanian Government stated that various agencies made initial savings from CTC of between 25 and 40 per cent with subsequent savings ranging from 20 to 25 per cent.

Local Governments

- the City of Melbourne reported savings of between 12 and 33 per cent for a variety of services, including home and community care, waste management and City promotion;
- the City of Port Phillip (Victoria) estimated saving \$180 000 (20 per cent of former internal cost) on domestic waste services;
- Clarence City Council (Tasmania) reported a saving of 40 per cent on the cleaning of public toilets; and
- the Evatt Foundation survey of local government reported that 30 per cent of respondents experienced cost increases in the contracting out of public works and services.

... and savings continue to accrue over time.

In examining whether any cost savings are maintained over time, it is important to be clear about the base on which the savings are being measured — the cost of internal provision prior to contracting or the cost if it were currently provided internally. The available evidence suggests that cost savings continue to be realised over time relative to the cost prior to contracting, but may vary (up or down) from those obtained initially. Often savings appear to decline over time when measured against the (actual or estimated) current cost of internal provision. This may result from the cost of internal provision falling in response to competition introduced through CTC.

Sources of savings

Identifying the sources of savings is important in evaluating CTC.

To evaluate CTC properly, there is a need to determine the nature and sources of any savings — and, in particular, to see whether the savings represent efficiency gains or whether at least some of the savings to government are offset by costs to other groups (for example, expenditure borne by another government).

Efficiency gains will generate net economic benefits to society from the better use of resources. They may derive from improved management and work practices or better use of equipment. In contrast, savings attributable to transfers or redistribution of resources between groups will not result in a net economic benefit to society unless the resources are used better.

Most of the savings represent efficiency gains...

The available evidence suggests that most of the savings from CTC do represent efficiency gains.

... from better management and work practices...

First, CTC has been associated with substantial improvements in management and work practices. One consequence of improved productivity is that fewer people may be needed to perform a given activity. For example, the introduction of a flatter management structure and redesigned work teams at the Amberley RAAF Base has facilitated a reduction in F-111 maintenance personnel from 356 to 214.

Second, CTC may allow public sector managers to devote more time and resources to strategic issues rather than day-to-day operations. Indeed, a greater management focus on strategic issues is widely identified as a key benefit from CTC.

... access to a wider knowledge base, skills, or technology...

Third, CTC can provide cost savings and other benefits by encouraging innovative solutions through access to a wider knowledge base, new ideas and/or new technology. For example, a tender submitted by a contractor to design and build a steel bridge instead of a concrete one for the Crystal Brook Bypass (SA) yielded reported cost savings of nine per cent.

... and better use of equipment.

Fourth, CTC can produce savings due to more productive use of capital or access to economies of scale. For example, the Department of Veterans' Affairs noted that contractors used operating theatres more effectively and intensively in delivering hospital services to veterans. Also, several agencies reported substantial savings from not having to maintain a permanent capacity to complete infrequent tasks.

Often the savings will come from a combination of these sources. Savings are evident across a broad range of capital- and labour- intensive services, in varying circumstances, and at all levels of government across Australia.

While some savings may simply be transfers...

While CTC clearly brings significant efficiency gains, these may be accompanied by some redistribution of resources between individuals and groups. In this context, the key concern of some participants was that savings from CTC are mainly due to lower wages and conditions or greater work effort that is not rewarded. Another possibility is cost shifting from one level of government to another. Two issues were raised. First, if resources were used in pursuit of savings which were predominantly transfers, there may be a net economic loss to the community. Second, there may be concerns that the transfers are inequitable.

... they are generally only a small component of savings.

Several considerations suggest that these concerns do not undermine the case for CTC. Most importantly, while transfers may be involved in particular cases, the available evidence suggests that they are generally a small proportion of savings made through CTC. From an economy-wide viewpoint, the appropriate action is generally to realise the efficiency gains and address directly any resulting equity concerns. In addition, any institutional arrangements which motivate agencies to pursue savings not involving real efficiency gains should be addressed directly (eg ending cost-shifting from one level of government to another) rather than by shunning CTC.

There are examples of reductions in wages and conditions...

The limited information available suggests that wages and conditions for those employed to deliver the service are often lower after the introduction of CTC. However, some examples were provided of higher wages. Individuals moving from the public to the private sector will sometimes also benefit from greater career and personal development opportunities.

... but these often reflect different awards in the public and private sectors or general labour market trends.

Changes in wages and conditions may often reflect differences in private and public sector awards, as well as general labour market trends such as the greater use of part-time and casual labour, and enterprise bargaining.

In some cases it is difficult to separate the savings from CTC from those attributable to other reforms, such as enterprise bargaining and local government amalgamations. All the same, agencies across the country have experienced savings from CTC, which suggests that at least some of the savings can be directly attributed to CTC.

Competition, or the threat of competition, is a major driver of savings.

The fact that substantial savings have been achieved even after internal reforms have been introduced, and where either in-house or external bidders win contracts, indicates that it is the competition introduced by CTC which is the overriding driver of savings. The threat of competition can provide a ‘demonstration effect’ for improvement in internal performance. For example, after private companies won the first two tenders to manage and operate prisons in Queensland, that State’s Corrective Services Commission improved its productivity to the point where a later contract (for the new Woodford prison) was won by an in-house team.

Broader social and economic impacts

A key concern is how CTC affects different groups.

CTC will have quite different effects on the people it touches — on public sector employees, on industry, on rural and remote areas, and on the community as a whole. Although the economy as a whole will gain from CTC, some particular groups may be disadvantaged.

Savings are distributed in a number of ways.

Some participants illustrated how the savings or benefits from CTC are distributed. Agencies in New South Wales and the Department of Defence are able to redirect savings generated by CTC to other priority areas. In other cases, savings have been passed on through lower taxes and charges. And in some cases, employees have shared in the gains through performance and productivity-based pay increases.

Public sector employees may be particularly affected.

While the benefits of CTC are likely to be spread widely, the costs are likely to be concentrated on certain groups. Employees in the area subject to CTC are potentially the most directly affected. The evidence before the Commission suggests that CTC will generally lead to a significant reduction in public sector employment as fewer people are required to perform particular tasks. The reduction will depend on a number of factors such as whether an in-house team wins the contract and whether savings are used on activities that generate public sector employment.

There is likely to be some increase in overall employment over time.

The initial reduction in public sector employment will be offset to some extent by increases in private sector employment resulting from the transfer of employees to, and the employment of others by, external contractors. Over time, improved use of resources in the economy as a result of CTC can be expected to generate higher real income and some increase in overall employment.

Certain groups of employees appear to have been adversely affected...

Some groups of employees are more likely to be adversely affected by CTC than others. To date, women, people from a non-English speaking background, and those employed in jobs requiring little training appear to have been the most likely to lose their jobs as a result of CTC. However, these groups comprise a large proportion of those working in the service industries which have been tendered or contracted out so far. For example, hospital cleaning services, whether government or private sector run, typically employ women from a non-English speaking background.

... highlighting the need for effective labour market programs.

These groups of employees have traditionally faced difficulties in the labour market. This highlights the importance of having effective labour market programs in place to assist them.

Social policy objectives

Governments at all levels often place great importance on the achievement of social objectives in the delivery of their services. This raises the question whether external contractors will effectively implement broader government policies on matters such as access and equity and equal employment opportunity.

CTC need not compromise social objectives in delivering the service.

Where these objectives are seen as an important element of the service being delivered (such as access to the service), they can generally be incorporated into the CTC process through the specification of contracts and/or the selection of contractors. For example, the Employment Services Regulatory Authority (ESRA) has selected contracted case managers for the long-term unemployed from a range of environments including people who are from a non-English speaking background (see box 5).

Box 5: ESRA contracted case management of the long-term unemployed

ESRA was established in 1994 to regulate arrangements for the introduction and accreditation of contracted case managers. The target number of job seekers managed by contracted case managers is 20 per cent of eligible job seekers in 1995-96.

Case managers may apply for either specialist or generalist accreditation. Specialist accreditation recognises the ability of case managers to provide services tailored to the needs of one or more identified special groups (including Aboriginals and Torres Strait Islanders, people with disabilities, people from non-English speaking backgrounds, young people and mature age people) or the ability to provide services to job seekers in particular industries or occupations.

Of contracts being negotiated for case managers across Australia, 381 are for general case managers and 256 for specialised. Contracted case managers are diverse in their backgrounds:

- there is roughly the same proportion of males to females;
- the ages of contracted case managers vary considerably, from 22 to 58 years;
- approximately 10 per cent are from a non-English speaking background or speak another language, and some are able to communicate with deaf people through sign-language;
- several have had significant career changes (often to a training or counselling role); and
- many have been involved in some form of community or voluntary activity.

Lessons

The introduction of competition, and in particular a system of accreditation of case managers, will assist in matching the skills and experience of service providers with the particular needs and circumstances of the individual job seeker.

Where other objectives, like EEO, relate to the employment conditions of all those working on the contract, specifying public sector policies and practices in contracts may significantly reduce staffing flexibility for contractors. Contractors could face, say, different agencies demanding they apply different EEO practices within their workforce (for example, a cleaning company providing services to the Commonwealth and State governments, the local council and private firms in a CBD). Pursuing these objectives through contract specifications can be a costly option.

CTC can provide opportunities for industry.

Industry development

The opening of government service delivery to CTC presents significant opportunities for firms to expand the scale and scope of their activities, to increase their knowledge and skill base, and to gain experience which may help in entering export markets.

Governments should be careful in pursuing industry development goals.

Governments sometimes use contracting to pursue industry development objectives. The costs of meeting industry development obligations may well be high where they are embedded into specific contracts. The greater the degree of flexibility that firms have in fulfilling their industry development obligations, the less likely that firms will be diverted from activities that reflect their competitive advantage.

RECOMMENDATION 3

While government purchasing can bring some industry development benefits, leverage should be used with caution and not simply because governments have scope to do so. Its use should be restricted to circumstances where there are strong grounds for expecting net benefits to the community over time. Net benefits are most likely to occur where industry development obligations are not sought through specific contracts and firms are given as much flexibility as possible in choosing activities that fulfil their obligations.

Where governments use two-envelope systems, greater transparency is needed.

Some governments seek industry development commitments under a system whereby tenderers are required to submit two-envelopes: the first detailing how the firm's tender meets the specifications and the offer price; and the second the industry development proposal associated with the tender. Unless a price is stated separately in each envelope, two-envelope tendering does not allow a government to determine whether the industry development commitments of a firm will generate a net benefit. It also makes it difficult to determine who is bearing the cost of the industry development component of the bid.

RECOMMENDATION 4

When governments use two-envelope tendering in pursuit of industry development objectives, tenderers should be required to state a separate price in each envelope. When the contract is awarded, any additional costs due to industry development obligations should be announced.

Local government purchasing preferences should be specified and costed.

Rural and remote areas

A key concern of those in rural and remote areas is how CTC affects local employment and the community. Some councils have addressed this concern by retaining work in-house. By doing this, councils may be forgoing the potential benefits of better utilisation of local resources and higher quality and lower prices in the delivery of services. By competitively tendering work and using contract specifications to meet community development concerns, councils may be able to achieve regional objectives more cost-effectively.

RECOMMENDATION 5

If local governments in rural or remote areas give preferences to local suppliers or require contractors to use local resources, that should be set down fully in the tender documentation; all tenders, including in-house bids, should identify separately the additional price for being required to use local resources; and when the contract is awarded, any additional cost due to a requirement to use local resources should be announced.

A full assessment of CTC needs to look at economy-wide effects.

Economy-wide effects

In addition to examining the likely effects of individual cases of CTC from an individual agency's viewpoint, a full evaluation of CTC needs to take into account how the effects feed through the economy.

The benefits of lower costs in government agencies across Australia may be passed on to industries that purchase their services as intermediate inputs. Cost savings in these industries in turn result in increased employment and production for both domestic and overseas markets. Lower costs may also be passed on through lower taxes and rates leading to higher disposable incomes.

To the extent that CTC results in labour-saving efficiency gains, labour is available for other productive activity in the economy. Any costs associated with short-term unemployment (eg unemployment benefits, retraining and redundancies) need to be offset against this.

Because it encourages more efficient use of resources...

The magnitude of the economy-wide effects of contracting depends on several factors:

- the further use of CTC by all levels of government (Commonwealth, State/Territory and local);
- the cost savings achieved; and
- the extent to which savings represent productivity gains or lower wages.

If savings are due to productivity improvements, this leads to growth in the economy. Cost savings through reduced wages, which result in transfers from one group in society to another, do not necessarily provide such opportunities.

While these factors are very difficult to quantify, the Commission felt it should provide governments with some information on the possible magnitude of the economy-wide effects. The Commission therefore undertook some modelling using a range of assumptions about the further use of CTC by all levels of government, the likely savings and their sources. The Commission considers these assumptions to be conservative, but cautions that modelling does not manufacture certainty out of the unknown.

... CTC is likely to lead to long-term economic benefits overall.

Because of these difficulties and uncertainties, eight different scenarios were examined. The modelling suggests that the main long-term impact of the further adoption of CTC would be on Gross Domestic Product (GDP), while the overall employment effect would be quite small over time. The long-term economy-wide gains might be in the range of 0.3 to 1.7 per cent of GDP a year — that is, \$1.3 billion to \$7.3 billion in 1993-94 dollars.

Improving the cost-effectiveness of CTC

CTC can be a valuable tool ... but action is needed to maximise its potential.

Having received examples of both effective and ineffective CTC, the Commission sought the reasons for success or failure. Outcomes depend on whether CTC is used intelligently and how it is implemented. The Commission has identified a number of ways to improve its cost-effectiveness.

Formulating government policies on CTC

CTC policies are at different stages.

Existing government policies on CTC in Australia reflect the differing emphasis they place on it in public sector reform. The policies are summarised in table 1.

Central guidelines should be developed as a matter of priority.

As the use of CTC has expanded, governments and agencies have sought to supplement general purchasing policies and guidelines with specific CTC guidelines. These can be valuable because CTC raises particular issues, such as defining the service to be contracted, managing an ongoing relationship between purchaser and provider, and handling in-house bids. Specific guidelines may also raise the awareness of managers of the CTC option and increase the confidence of bidders in the tender process.

RECOMMENDATION 6

Those governments which do not have specific CTC guidelines should develop them as a matter of priority. They could usefully draw on guidelines which have already been issued by several State governments. The guidelines should be sufficiently detailed to be of practical use, but flexible enough to take account of the different types of service, market characteristics and agency circumstances.

Table 1: Summary of Commonwealth, State and Territory Government CTC policies

<i>Main features</i>	<i>Commonwealth</i>	<i>NSW</i>	<i>Vic</i>	<i>Qld</i>	<i>WA</i>	<i>SA</i>	<i>Tas</i>	<i>ACT</i>	<i>NT</i>
Are there CTC-specific guidelines?	No	Yes	Yes	Policy under consideration	Yes	Yes	Being developed	Being developed	No
Is there compulsory competitive tendering?	No, only in some cases	No	Only for local government	Policy under consideration	No	No	No	No	No
Are in-house bids allowed?	Yes	Yes	Not encouraged	Policy under consideration	Yes, in some cases	Yes	Not encouraged	Policy under consideration	No
Is industry development an evaluation criterion?	Yes, for large & IT purchases	Sometimes	Sometimes	Policy under consideration	Yes	Yes, for large purchases	Sometimes	Policy under consideration	Sometimes
Can the agency retain savings?	Yes, in some cases	For priority programs	No	Policy under consideration	Yes	Yes, if agreed by Cabinet	To be resolved	Policy under consideration	No
Are costing guidelines available?	Yes	Yes	No	No	Yes	Being developed	No	No	No
May the public sector compete in the private sector?	Yes	Not usually	No	Policy under consideration	No	No	No	Yes	No
Are detailed CTC manuals available?	For Defence & AusAID	No	Yes	No	Yes	No	No	Being developed	No

Source: See Appendix B

One issue is whether agencies should be compelled to use CTC.

One issue that has sparked great debate is the compulsory use of competitive tendering. This involves imposing mandatory targets on agencies to competitively tender either specific services or shares of total expenditure. In Australia, the most notable example of compulsory competitive tendering is in Victorian local government.

While doing so may accelerate reform, it may also impose costs.

Some see compulsory competitive tendering as a useful tool to accelerate the pace of public sector reform, particularly where existing institutional features are likely to delay reform. Others are concerned that compulsory targets may lead to CTC being used where it is not the most cost-effective option.

It should not be necessary to mandate CTC...

Directives on the use of CTC need to be considered in the broader context of incentives for effective and efficient management in the public sector. Where public sector management systems are operating efficiently, it should not be necessary to mandate the use of a particular management tool such as CTC. However, when these incentives are not operating, compulsory competitive tendering may be the best available option.

... but doing so may sometimes be the best available option.

Where compulsory competitive tendering is adopted, a further issue is the form the targets should take. A difficulty with nominating specific services is that the agency choosing the particular services, especially if it is removed from or has little experience in their delivery, may not be able to identify those services which would benefit most from being competitively tendered.

RECOMMENDATION 7

The Commission does not advocate compulsory competitive tendering. However, if governments choose to adopt it, they should base it on a percentage of total expenditure, rather than nominate specific services to be tendered.

Making good decisions on when to use CTC

Because CTC is a means to an end, not an end in itself, it should be used only where it will achieve an agency's objectives. That should form the basis of any assessment of the scope for CTC.

A review of agency programs and functions may be needed first.

A review of the agency's functions (including consultation with clients and other stakeholders) may be an essential first step in assessing the scope for CTC. It has several benefits:

- it identifies the agency's current activities;
- it helps to identify the policy goals (both service specific and broader goals) which each program or activity is attempting to achieve; and
- it can assist in identifying areas where services are ineffective in meeting the policy goals.

There are problems with categorising areas suitable for CTC.

Some participants nominated particular services which would be most suitable for CTC (for example, cleaning and refuse collection) or argued that functions could be divided into 'core' and 'non-core' activities.

Basing the suitability for CTC on type of function does not seem robust. Significant exceptions can be found. For example, some suggest the delivery of services is more amenable to CTC than, say, policy development and regulatory activities. But there are instances of external provision of both policy development (for example, recent State Audit Commissions) and regulatory activities (for example, industry codes of practice).

There is a further danger in approaches which rely on broad categorisations. For example, the environment in which a service is provided may change over time as a result of changes in governments or their policies, advances in technology, or changes in social and economic conditions. Similarly, what is 'core' for one agency may be peripheral for another (for example, legal services).

A case-by-case approach is needed...

The scope for CTC should not be considered on the basis of broad categorisations of services or the characteristics of those services. Instead, assessment of the scope for CTC should be made on a case-by-case basis.

Prior to any detailed assessment of the scope for CTC, any binding constraints should be identified. They may arise from international commitments, or from constitutional or other domestic legal considerations. But agencies should preclude from consideration only those activities specifically constrained, not activities related to them.

... assessing a number of risks and their costs.

Determining when it is appropriate to use CTC should involve an identification of the risks and an assessment of their costs. It is not sufficient simply to identify risks and use them as a basis for ruling out the use of CTC. Rather, managers should seek to identify and evaluate the risks involved and ways of overcoming them. The risks may be grouped into those pertaining to the particular service, the market, and the agency.

In light of these considerations, the Commission has developed some indicative principles for assessing the scope for CTC in recommendation 8. It recognises that a number of governments and/or their agencies throughout Australia have included many of these principles in their guidelines.

RECOMMENDATION 8

Governments and their agencies should assess the scope for competitive tendering and contracting on a case-by-case basis. In doing so, they should consider the following indicative principles.

The process takes time and is not costless. The degree of formality agencies attach to it should depend on the complexity of the services involved and the likely cost of their delivery. The items listed should not be used as an excuse for inaction but they should be considered carefully in each case.

A *Identifying the constraints*

- Identify any functions which for constitutional or other legal reasons or because of international commitments, must be carried out by public officials only.

B *Reviewing functions*

- Identify the functions of the agency in terms of its policy goals.
- Consult customers and other stakeholders about the services that are required to meet these policy goals.
- Assess whether the existing services meet requirements and determine whether the range of services and/or their quality should be changed.
- Assess the full costs and benefits of the existing method of service delivery.

C *Identifying the alternatives*

- Where the function is new to the agency, consider CTC as a possible means of delivery from the outset.
- Identify other service delivery options.
- Compare the other service delivery options with the existing method. Depending on the size and importance of the activity and the likely benefits to be gained, this may require a formal process such as benchmarking or less formal processes.
- Make some assessment of the likely net costs of the CTC process.

D *Assessing the suitability and risks of CTC*

CTC involves a number of risks. This should not preclude its use. However, the likely cost of all the risks and ways to minimise them should be assessed. The following questions should be addressed (not necessarily sequentially), to enable an overall assessment to be made.

Service-specific factors

- Are there any accountability, privacy, security, consumer protection, access and equity or other policy considerations that cannot be addressed satisfactorily through contract specification and contract management and performance monitoring? The less difficult these considerations are, the greater is the case for CTC.

- How easy is it to specify the service (particularly in terms of outputs rather than inputs), measure the output of the service and measure the performance of the contractor? The easier these things can be done, the greater is the case for CTC.
- How serious are the consequences of service interruption arising from contract failure? How likely is such a failure and is there any way to minimise this likelihood or the costs of interruption? The less important these factors are, the greater is the case for CTC.

Market-specific factors

- Is there an established market for delivery of the service and what is the level of competition or potential competition in that market? The stronger an established market is, the greater is the case for CTC. If there is not an established market, assess the likelihood of a market developing and its competitive strength.
- How easy is it to penalise contractors or replace them for unsatisfactory performance without significantly interrupting service delivery? The easier it is to penalise or replace contractors, the greater is the case for CTC.

Agency-specific factors

- Does the agency have, or have access to, the skills required to draw up specifications, evaluate tenders and manage the contract? The case for CTC is greater where those skills are available or can be obtained.
- What are the likely industrial relations implications of moving from direct government delivery to CTC? CTC is easier to implement where it is less likely to cause industrial disruption.
- Would CTC reduce the management resources used in providing services which are less important in achieving the agency's goals? Where the service takes up a disproportionate amount of management resources, the case for CTC will be stronger.

E Weighing the costs and benefits

- Assess the likely full costs of CTC, including the costs of service delivery, transition costs and contract monitoring and management costs.
- Make an overall assessment of the costs and benefits of CTC compared with other service delivery options. This comparison should be made on a net present value basis.

Ensuring effective competition

Ensuring effective competition is vital.

Competition is a key driver of many of the potential benefits available from CTC. Ensuring effective competition is therefore vital. This raises questions as to what is being competed for, how often competition takes place, who is allowed to compete, and the basis on which they compete.

Choice of contract size should take account of the effect on competition... In deciding how to ‘bundle’ services for tendering, a number of factors need to be taken into account (for example, the extent of economies of scale and scope). Agencies should also be aware that the size of the contract may discourage, or even prevent, some persons from participating in the tender process.

RECOMMENDATION 9

Agencies should determine contract size on a case-by-case basis, with reference to:

- the service and market characteristics (for example, economies of scale and scope and the potential for innovation);
- administrative or transactions costs (and whether the agency or an external contractor is best able to manage these costs); and
- the need to ensure effective competition.

... as should the length of contract. The length of the contract may influence the degree of competition involved in delivering a service. Difficulties in anticipating all eventualities mean that longer contracts may carry greater risks of inadequate performance. For example, the City of Unley in South Australia found that its ten-year refuse collection contract locked it into paying for a service which became outdated and expensive relative to market trends.

Longer contracts may also advantage incumbent suppliers and effectively lock out potential competitors. The length of contract will need, however, to take into account the need for contractors to recoup sunk investments in capital or labour training. For example, contracts for refuse collection have commonly been for around seven years to enable contractors an adequate return on the specialised vehicles used.

While strategic alliances can bring benefits, care must be taken to ensure competition is maintained.

Strategic alliances can offer significant benefits, particularly contracts requiring a high level of service quality, where continuity of supplier is important (for example, for some social welfare services) or where a relatively high degree of uncertainty exists. However, it is important to ensure that the benefits of competition are captured through a contestable initial tender and through the ability to switch providers if required.

RECOMMENDATION 10

Contract length should be determined with reference to:

- the need for contractors to recoup significant sunk costs;
- the desirability of continuity of client-contractor relationships, particularly in community services;
- the possibility of fundamental policy changes affecting service provision; and
- the need to ensure an effective level of competitive pressure.

In some cases competition is limited...

Calling tenders will not always guarantee effective competition. In some cases, the characteristics of the market or the service may lead to relatively low levels of competition. This was of particular concern to many in rural and remote areas.

Transferring service provision from a public to a private monopoly through CTC may bring no benefits and may even result in higher costs and poor service responsiveness. An agency which contracts out in these circumstances may find itself in a vulnerable position where it no longer has access to skills or assets to re-enter the market itself.

... so measures should be taken to facilitate competition...

In cases of limited competition, emphasis should be placed on creating an environment conducive to potential competition (for example, by distributing information to a wide range of potential contractors). Where a market is characterised as a natural monopoly, it may be possible to have competition for the right to deliver the (monopoly) service. One potential solution is to have an operating lease where the agency retains ownership of the assets (for example, the equipment for a regional radiology service), but calls tenders for the right to operate them.

RECOMMENDATION 11

Where natural monopolies exist, agencies should separate the contestable from the non-contestable elements of the service, and consider using operating leases for those natural monopoly elements with significant sunk costs.

... including impartial tender processes and independent evaluation...

To reduce the perception that particular bidders are favoured in tender selection processes, agencies should ensure that specifications are framed after consultation with a range of stakeholders, not only the incumbent supplier, and they should consider using independent representatives on evaluation panels (see recommendation 22b and 22q).

... and protecting the agency's reputation for genuine competitive tendering.

Another common concern is that agencies use tender processes to gain market and product information from tenderers with no intention of awarding a contract externally, or without sufficient forethought as to the service required and how much the agency is prepared to pay. Such behaviour is likely to undermine the benefits from CTC by inflating tender prices or reducing the level of competition.

The preferred solution is for an agency to improve its tendering processes. While the option not to proceed to contract must remain with the agency, it may wish to consider compensating tenderers for some of their cost of tendering where it needs to restore confidence in its commitment to competitive tendering.

In-house bids

In-house bids raise additional issues.

An in-house bid refers to a situation where an internal team, often based on the existing internal provider, participates in the tender process and, if successful, supplies the required service on a 'contractual' basis. The concept of an in-house bid raises a range of issues.

They involve both benefits and costs...

Agencies need to consider the various benefits and costs associated with an in-house bid. For example, in-house bids may provide benefits by ensuring a deeper supplier market or facilitating human resource management, but they may impose costs such as additional probity requirements. These factors are likely to vary significantly between agencies and services, and over time.

... so decisions on whether to allow them should be made on a case-by-case basis...

As a result, agencies should examine their individual circumstances in deciding whether to allow in-house bids.

RECOMMENDATION 12

Agencies should consider the option of an in-house bid when an activity is competitively tendered. The decision whether to allow an in-house bid should be taken after weighing the costs and benefits in each case.

... taking into account alternatives. Agencies should take into account alternative ways of achieving the benefits of an in-house bid without some of the associated costs. For example, a management/staff buy-out may provide another avenue for the in-house team to tender for contracts.

In-house teams may receive both advantages and disadvantages from public ownership. Governments and their agencies operate in environments which confer on them a number of advantages and disadvantages relative to external suppliers of services. For example, government agencies are often exempted from government taxes and charges. Public ownership may provide effective immunity from bankruptcy, but may also bring with it more onerous accountability or employment obligations.

Where in-house bids do occur, effective competition requires competitive neutrality. Competitive neutrality refers to those administrative and legal arrangements which treat all organisations and individuals in an equivalent manner including public, private and not-for-profit service providers. This is a key issue to be addressed in implementing a national competition policy.

Organisational separation of the purchaser and provider is crucial. Organisational separation of the purchaser of the service from the provider can aid competitive neutrality by:

- separating the in-house team from all aspects of service regulation and specification, tender evaluation and contract management;
- introducing a degree of commercial autonomy, including the discipline of a requirement to cover costs and provide an appropriate return on capital; and
- creating a more transparent relationship between the in-house provider and the contracting agency.

RECOMMENDATION 13

Where there is to be an in-house bid, it should be prepared by an organisational unit which is separate from all aspects of service regulation and specification, and tender evaluation.

There are two main options.

Corporatisation aims to convert a public enterprise into an organisation which is closer in its objectives, incentives, sanctions and operational flexibility to a private firm, while retaining public ownership. Under this model the in-house team becomes a legal entity distinct from the parent agency.

Commercialisation generally involves a government directive to a public agency or authority to conduct all or some of its operations, as far as possible, on a commercial basis.

At a minimum, successful in-house teams should be managed as commercially autonomous units.

At the very least, in-house teams should operate as commercially autonomous units, with separate accounts. In doing so, agencies should ensure that measures to achieve competitive neutrality (for example, pricing directions) are in place and effectively enforced.

RECOMMENDATION 14

Where an in-house team wins a tender, it should be managed, at the very least, as a commercially autonomous unit, with its own set of commercial accounts and formally separated from all aspects of contract management. Monitoring and reporting arrangements should be established to ensure that the agreed price and performance standards are achieved. However, the Commission recognises that some governments and agencies will wish to go further than this minimal position and corporatise the in-house unit.

But corporatisation is the preferred approach...

Concerns over the effectiveness of the incentive structure facing public sector managers point to a greater role for corporatisation.

... particularly where agencies compete in new markets or engage in loss-leading...

Where agencies intend to bid for contracts in non-traditional markets, or engage in loss-leading pricing practices, there is a strong case for adopting the corporatisation model.

... though it may not be practicable in some circumstances. Corporatisation may not be appropriate in all cases. Particularly for small activities, the administrative costs of corporatisation may outweigh the benefits. The circumstances when commercialisation may be an acceptable substitute should be examined further.

In those cases where agencies consider that the benefits of transferring the in-house team to a corporatised environment are outweighed by the costs, the onus should be on the agency to show that an alternative organisational structure is more appropriate.

RECOMMENDATION 15

Corporatisation is the preferred approach to achieving competitive neutrality, but may not be appropriate in all cases. The circumstances when commercialisation may be an acceptable substitute should be examined further. This examination should consider wider issues of the role for corporatisation in public sector reform, whether and what restrictions should be imposed on the trading activities of business units when corporatisation is not considered appropriate, the appropriate form of corporatisation and implementation processes. This task could usefully be taken up by the Council of Australian Governments.

Competitive neutrality may be affected by differences in tax treatment. Where corporatisation is not adopted, governments should take other steps to promote competitive neutrality. In particular, they should address differences in tax treatment between in-house and external suppliers.

RECOMMENDATION 16

In-house suppliers should be made effectively liable for all relevant taxes and charges, with payments made, where practicable, to a central revenue body.

All relevant costs should be included in preparing in-house bids. To avoid contracts being awarded on the basis of an inaccurate assessment of the real cost of service provision, it is essential that the costing method for in-house bids cover all costs. These include overheads and other costs such as an appropriate return on capital.

Whatever costing method is employed, agencies should ensure that:

- they avoid overly complex costing methods;
- they consider the issue of materiality — it is not worth going through a costly allocation process for relatively small cost imposts; and
- their costing systems are transparent (in terms of underlying assumptions and the calculations themselves) to maintain external confidence in the costing of in-house bids.

RECOMMENDATION 17

Agencies should be required to include an appropriate rate of return on capital in costing in-house bids.

RECOMMENDATION 18

To calculate the relevant costs attributable to an in-house bid (for the purposes of bid preparation), the Net Avoidable Cost method is the preferred method. However, where the Net Avoidable Cost method is too costly to implement, other costing methods such as Activity Based Costing may be more appropriate.

The treatment of redundancy costs is important.

Different agencies and jurisdictions are treating redundancy costs differently in tender evaluation. But the various approaches may affect the choice of preferred contractor and the contracting outcome. As a real (and sometimes significant) cost to agencies, redundancy costs should be taken into account in tender evaluation. However, the Commission recognises that this may present some practical problems, particularly where negotiated transfers of employees to external contractors are involved.

RECOMMENDATION 19

Agencies should estimate redundancy costs, include them in the tender documentation and take them into account in the evaluation of external tenders. Redundancy costs should be amortised over a suitable period, which is likely to be between five and ten years.

Moves to accrual accounting may need to be accelerated.

The introduction of accrual accounting in the public sector will reduce the problems associated with cash-based accounting. However, it is likely to be some time before these reforms are fully implemented. Accelerating these reforms would enable better costing of in-house bids.

RECOMMENDATION 20

Where in-house bids are permitted and accrual accounting is not already in place, contracting agencies should consider accelerating the implementation of accrual accounting.

In-house teams may need some time to improve their competitiveness.

Where agencies decide to allow in-house bids, consideration should be given to whether in-house teams should be given time to 'get up to speed'. This can yield benefits (see box 6). However, agencies should recognise that selecting a long adjustment period will delay the realisation of the benefits of CTC and may threaten the implementation of CTC reforms overall.

RECOMMENDATION 21

Agencies should specify the period of time that in-house teams are to be given to improve their competitiveness before the competitive tendering process starts. This period should be as short as possible, but no more than two years.

Box 6: City of Melbourne approach to preparing in-house teams

In 1990, the Council introduced reforms to reduce operating costs and rationalise services, including a major activity review, workplace restructuring, job redesign, enterprise bargaining, benchmarking and the introduction of new technology. These reforms achieved substantial cost savings and made internal providers more competitive before the transition to CTC in May 1994.

Reforms introduced as part of the CTC process included market testing, outsourcing of uncompetitive services and commercialisation. Among the services contracted so far are: parking meter coin collection, superannuation fund administration, City marketing and information technology software development. The Council is also considering market testing youth services, traffic and civil engineering design, property maintenance and libraries.

In-house teams, structured as separate business units within the Council, have won contracts for home and community care, swimming pool management and property valuation, waste management, parks and gardens maintenance, and parking meter maintenance.

The Council claims that the strategy has improved service quality and is delivering cost savings of 15 to 20 per cent.

Lessons

In-house providers can become more efficient and competitive over time as a result of continuous changes to work practices. Large savings through CTC can be enhanced by the implementation of other internal workplace reforms.

An effective tender process

The tender process can significantly affect the outcome of CTC.

The extent to which contracting of services provides benefits to the client agency, and the community more generally, is largely dependent on the efficiency and effectiveness of the competitive tendering process. If tendering mechanisms are poorly or inappropriately designed or implemented, the costs imposed on the client agency, prospective contractors and others (eg taxpayers and clients) may reduce or overshadow any potential benefits.

There are some general 'best-practice' guidelines which agencies should follow...

There are a number of practices which agencies should adopt as a matter of course. For example, service requirements should be specified in clear and accurate terms within an easy-to-follow format. A list of 'best-practice' guidelines, which the Commission recommends agencies adopt, is presented in recommendation 22.

... including consulting widely. Obtaining the views of clients or their representatives, as well as existing and alternative service providers, about the proposed specification of a service can result in better specification and contract performance. But consultation with stakeholders should be kept in perspective: while it is undoubtedly beneficial, it takes time and resources.

Some aspects will vary on a case-by-case basis... The appropriate tender process and contract type will vary between agencies and activities. Agencies should design the tender process and select an appropriate contract type based on the characteristics of the service and the incentives and penalties required to achieve the desired outcome.

... such as services where it is difficult to specify outcomes... Some aspects may need to vary according to the type of service. For example, while specifying service requirements in terms of outputs or performance is generally preferred (because they provide contractors with the choice of how best to achieve desired outcomes), this may be particularly important where the contracting agency is unaware of the range of possible ways of achieving the desired result. Similarly, multi-stage tendering is particularly appropriate where service requirements are unclear or there may be several solutions, or the service requirement is relatively complex.

... or where quality outcomes are paramount. For some services such as human services, design specifications (which document either the required process or design characteristics of the service) may offer a higher degree of certainty that desired outcomes will be achieved. Similarly, Qualification Based Selection may be worthy of consideration for complex projects where quality and client satisfaction are paramount outcomes, particularly where it is difficult or costly to monitor contractor performance accurately.

RECOMMENDATION 22

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 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.

Human resource management

Moving to CTC involves a major cultural change.

The CTC process involves a change in some functions of government agencies, away from direct service delivery and regulation to being a purchaser of services. The transition can often involve significant reorganisation, job re-specification, training and changes to work practices.

Senior management commitment and consultation with staff is vital.

As well as the support of Ministers/Councillors, the commitment of senior management is therefore essential to achieve a smooth transition to CTC. Early and open consultation is desirable with staff and their representatives about the intention to introduce CTC, the process and timing that will be followed, employment opportunities and entitlements for staff.

CTC requires a new mix of skills.

The transition to CTC requires agencies to evaluate the extent to which they have or can obtain the necessary skills to administer and manage the process. Skills in assessing the scope for CTC, contract specification, negotiation, tender evaluation, contract management and performance evaluation will all be needed, as will the capacity to prepare in-house bids, where they are to be made. If government agencies do not have those skills, there are a number of strategies available to acquire them — see box 7 on the experience of Victorian local government.

RECOMMENDATION 23

Where agencies are inexperienced or lack the confidence necessary to effectively manage the CTC process, they should consider strategies such as making greater use of available training and information, drawing on the experience of individuals and organisations outside the agency through recruitment or skills transfer, or staging the CTC process.

Box 7: Learning from experience: Victorian local government

In 1994, councils in Victoria were required to tender at least 20 per cent of total expenditure in 1994-95, increasing to 30 per cent by 1995-96 and 50 per cent by 1996-97. Councils have moved to access a range of new skills in prioritising services for contracting, developing specifications, negotiating tenders, and managing contracts. There have been a number of developments to meet this need for new skills:

- experienced private sector people have been recruited and consultants used to work with council staff;
- comprehensive CTC manuals have been developed by a number of agencies;
- the Municipal Association of Victoria has published documents and established a training program to assist councils to identify the scope for tendering, manage the process, write tender specifications, establish business units and develop a costing framework;
- the Office of Local Government has developed a 'Code of Tendering' in consultation with council officers and contractors;
- a market has emerged for the exchange of contract and tender documents between local government agencies; and
- the Institute of Municipal Management has sought to establish a 'clearing house' for councils to buy and sell contract and tender documentation.

Lessons

Councils are using a range of methods to address the skills shortage. The skills market is developing well.

There are two broad approaches to managing excess staff: the 'clean break' and the 'negotiated transfer'.

As noted earlier, CTC may result in fewer people being required to perform a particular function. There are two broad approaches to managing excess staff, the 'clean break' and the 'negotiated transfer' approaches. Circumstances are likely to make one more appropriate than the other, so it is not sensible to prescribe which approach should be taken by individual agencies.

Unnecessary employment restrictions should not be placed on contractors.

Requiring contractors to take on public sector employees or to employ them under public sector wages and conditions may impose significant costs. Employees may not be suited to the organisation or public sector wages and conditions may differ from the relevant private sector award or the industry norm.

While some form of compensation or incentive payment may be appropriate...

Arrangements for the transfer of staff may appropriately be agreed by negotiations involving the successful bidder, the agency and its staff and their representatives. In some cases it may also be appropriate to provide some form of compensation or incentive payment to staff who, on transfer, lose some employment conditions, for example, job security or some superannuation benefits.

RECOMMENDATION 24

Contractors should not be required to employ any given number of displaced public sector employees, nor should they be required to employ them on their existing public sector terms and conditions. The terms and conditions of any public sector employees who transfer should be settled through negotiations involving the contractor, the government agency and its staff and their representatives. Contractors should be free not to offer a transfer position to any particular member of staff. Employees should be free to reject a job offer and retain entitlements to redeployment and redundancy.

... 'double-dipping' should be prevented.

'Double dipping' refers to the situation where employees accept a formal job offer from the contractor (as a result of a negotiated agreement with the agency) and also have access to a voluntary redundancy payment. Double dipping is undesirable because it allows individuals to improve their financial situation by receiving a redundancy payment as well as accepting a job with the contractor: this significantly increases the cost of CTC to tax and ratepayers.

RECOMMENDATION 25

Where a contractor, the government agency and its staff and their representatives negotiate a transfer package (including, where appropriate, some form of compensation or incentive payment to employees) and an employee is offered and accepts the package, this should negate the employee's ability to claim the payments for voluntary redundancy available to public sector employees who do not transfer. Those who accept voluntary redundancy offered as a result of contracting out should be precluded from working with the contractor on the relevant outsourcing contract for a period of time.

Facilitating the transition to CTC

Agencies can use a number of measures to aid the transition to CTC...

Measures to facilitate the transition to CTC may include in-house bids, compulsory competitive tendering requirements, compensation to affected groups and reservation of part of the market for internal provision. Adjusting the speed of implementation or changing the order of activities subject to CTC may also be helpful.

... but these should not compromise the progress of reform.

But such measures should not compromise the progress of reform more generally. Agencies should ensure that any measures are temporary, implemented only where the benefits outweigh the associated costs, and are transparent.

Some broader policy changes will also facilitate CTC...

The policy changes implemented at a whole-of-government level can both drive and facilitate change. Policy developments at a broader government level (for example, reforms to Australia's competition policy regime) may facilitate CTC reforms at an agency level.

... while others need to be addressed ... without compromising government objectives.

More effective use of CTC will also require some broader policy changes to remove unnecessary biases on its use. For example, some inter-governmental funding arrangements may promote decisions on CTC motivated by the prospect of shifting costs on to another level of government rather than improving service delivery; others may impose conditions on program delivery which inhibit contracting. And some government regulations may unintentionally restrict the use of CTC. While reform in these areas should not be driven by their effects on decisions on CTC, any review of these arrangements should ensure they do not unnecessarily undermine the use of CTC.

Beyond this inquiry

As CTC becomes more widespread, new issues will emerge...

More widespread consideration of the contracting option has the potential to transform not only individual public sector agencies, but also their relations with taxpayers and other levels of government. These changes will have important implications for accountability, management of service delivery, and other aspects discussed in this report.

... such as the value added to service delivery by government involvement...

Through more transparent specification of services and closer monitoring of their delivery, CTC makes explicit the relationship between the agencies and their clients. It provides governments with the opportunity to place much greater emphasis on desired outcomes and determining the best means of achieving them. While governments will continue to play an important, but changing role in service provision, there will be increasing focus on the fundamental objectives of their intermediation — whether that be equity/redistribution, standards setting, addressing market failure, community development, protection of individual rights, public safety, or some other objectives.

... and how different agencies and levels of government should interact.

Where more than one agency or level of government is involved in the chain between taxpayer and client, the contribution of each party as an intermediary will come into greater focus when the service being provided has been transparently specified, costed and monitored. This raises questions such as what level of government is best able to specify, select and monitor the provision of the services? And how can activities be better coordinated across agencies or levels of government — for example, where people, such as the unemployed, use the services of a number of government agencies? These and related questions involve much broader considerations than it has been possible to canvass in this inquiry, but they need to be addressed.

COMPETITIVE TENDERING AND CONTRACTING BY PUBLIC SECTOR AGENCIES

Part A Background to the inquiry

A1 The inquiry in context

**A2 The extent of competitive tendering and contracting of
services**

A1 THE INQUIRY IN CONTEXT

A1.1 The broad context

In recent years there has been a range of social, economic, and technological pressures on government to become more effective and efficient. Budgetary imperatives have intensified the scrutiny of government expenditure. Public attitudes towards government are changing: the community is demanding a bigger say in the planning, organisation and delivery of services, and greater accountability for results. Bureaucratic ‘one size fits all’ approaches are being rejected. Governments face challenges to become more adaptable and to get better value for money both for services which government uses as inputs to its own processes (eg information technology (IT) and corporate services) and to those delivered to the public on behalf of governments (eg garbage collection, health services).

Governments in Australia and other countries have responded in a number of ways. They have introduced two broad types of reform:

- those which focus on internal management processes through improving information systems and clarifying responsibilities and outcomes required to better evaluate performance (eg financial management and budgetary reforms, accrual accounting, enterprise bargaining, benchmarking, devolution of responsibilities to agencies, human resource management reforms, corporate and strategic planning, and user charges); and
- those which seek to harness market-based incentives (eg commercialisation and corporatisation and, in some cases, privatisation) and expose public services to competition or the threat of competition.

This inquiry is about one instrument which incorporates elements of many of these reforms: competitive tendering and contracting (CTC). That involves clearly defining services which have traditionally been provided by public sector agencies and then periodically opening them to competition with external providers.

While public sector reforms have varied in their application and in the particular instruments adopted, they share the underlying objective of improving the efficiency and effectiveness of government program delivery. As the Commonwealth Department of Administrative Services observed:

A fundamental issue facing any government is to determine the most appropriate and cost-effective means to ensure its priorities and objectives are met. The trend of public sector reform over the last ten years, among governments within Australia and across the OECD, has been to enhance measurable performance and accountability within their public sectors. (Sub. 140, p. 7)

The increasing focus on how government can best achieve its objectives has led to some fundamental re-thinking about how it operates. The need to provide public sector agencies with greater flexibility to explore alternative methods of service delivery has been increasingly recognised. Delivering the 1994 Sir Robert Garran oration, the Minister for Finance, the Hon. Kim Beazley MP observed:

Government has traditionally been seen as a provider of services. Today Government can also be about purchasing services on behalf of its clients, and it will look increasingly to buy from the most efficient supplier, whether from within the public sector or externally ... As our experience with contracting ... grows, there is likely to be continuing pressure to extend contestability within the public sector as a device to improve efficiency and, at the least, maintain the effectiveness and client focus of program delivery.

Similar reform programs are being pursued in other countries.

CTC for the provision of public services is not a new phenomenon. However, in recent years, there has been a growing interest in its use at all levels of government in Australia. The effect is being felt across an increasing range of services, extending to areas sometimes considered the exclusive province of government (eg prisons, employment services and policy analysis). There are parallel developments in the private sector, both in Australia and overseas.

The growth of contracting has raised questions as to whether the policy framework has kept pace, and whether existing arrangements provide effective guidance for agencies embarking on CTC.

A1.2 Scope of the inquiry

The terms of reference for this inquiry are reproduced in full at page xiv. Specific matters the Commission was asked to report on include:

- the nature, extent and scope of contracting out by public sector agencies;
- the costs and benefits of contracting, including the effect on government bodies with respect to value for money, quality of service and accountability;
- past successes and failures of contracting;
- the effectiveness of existing mechanisms for contracting;

- the implications for employees and their terms and conditions of employment; and
- the development of a set of indicative principles for public sector managers to use in assessing the scope for CTC.

The reference sent to the Commission was titled *Contracting Out by Public Sector Agencies*. The terms of reference defined contracting out as an arrangement whereby a government body enters into a contract with an external or government supplier for the provision of goods and/or services.

The Commission has included and examined those competitive tendering processes which involve bids from within the organisation ('in-house bids'). In this sense, the inquiry is as much about competitive tendering or 'market testing' as about contracting out or outsourcing. The Commission has therefore entitled the report *Competitive Tendering and Contracting by Public Sector Agencies* to reflect more accurately the terms of reference. Emphasis is placed on the concept of competitive tendering: the process where bids are called for the supply of certain goods or services and a winning tenderer is selected on the basis of specified criteria such as cost, service quality and value for money.

An important corollary is that this is not an inquiry about privatisation of government services. Indeed, because governments retain control over service provision (including the choice of which services are provided, at what level and in what manner), there are important distinctions between CTC and privatisation.

The inquiry covers CTC by Commonwealth, state, territory and local governments and their agencies. It therefore extends to all levels of government and to a variety of organisations. While it does not cover contracting by the private sector, it has drawn on this experience where appropriate.

This report covers a vast range of activities: from services provided to government (eg IT, printing, design and maintenance of buildings, car fleet management and corporate services such as payroll, recruitment and finance) to services provided directly to the public either as a standardised service (eg garbage collection or income security) or as an individualised service (eg health or welfare services). It does not examine all aspects of government procurement, particularly inputs of goods such as office requisites.

The inquiry encompasses contracting to the private sector and not-for-profit organisations and contractual relationships between different government agencies, including between different levels of government. It covers a wide range of contractual and quasi-contractual situations (including strategic

alliances, resource sharing, inter- and intra-agency contracting, and contracting to not-for-profit organisations).

A1.2.1 Key issues

This inquiry raises many issues on which major stakeholders have different perspectives. Taxpayers and ratepayers want to see public money spent efficiently and equitably, while ensuring that a range of quality services are provided. Potential contractors want fair opportunities to compete for what can be significant markets. Public sector employees and their unions want to protect the public delivery of the services. Those in rural and remote areas are concerned about the effect of competition on the local economy.

At the heart of the debate is whether — and under what circumstances — CTC leads to better policy outcomes than direct public provision.

There are two essential differences between CTC and traditional internal provision. First, under CTC there is usually an organisational separation of the purchaser of services from the provider: this is sometimes referred to as the purchaser/provider split. Second, CTC introduces contestability to services previously shielded from the discipline of competition.

CTC aims to improve the efficiency and effectiveness of services delivered to (or for) governments. The clarification of purchaser/provider roles can enhance accountability by specifying the outcome sought by government (the purchaser) and the requirements on the service provider. Competition allows greater choice of suppliers and ways of providing services. Consequently, CTC seeks to facilitate the most efficient and effective way of meeting an identified requirement of governments, improving the outcomes for clients and the community as a whole.

The debate about CTC largely revolves around whether these two features of CTC do in fact lead to better outcomes compared with direct public provision, and whether the formal separation between service specification and delivery undermines the achievement of policy goals.

Advocates of CTC point to increased flexibility in service delivery, greater focus on outputs and outcomes rather than inputs, the release of public sector management from day-to-day operations to enable them to concentrate on strategic issues, the encouragement of suppliers to provide innovative solutions and savings in the cost of providing services.

Others question the extent of these benefits, pointing, for example, to the sometimes substantial costs associated with contract specification, the

competitive tendering process, and on-going monitoring. Concerns have also been expressed that any savings may largely reflect reductions in quality or cuts in jobs, wages and conditions. Questions as to the potential effect of contracting on accountability, privacy, probity, and consumer protection have also been raised.

The report examines key issues in the debate, including: the effect on accountability and service quality; the extent, source and sustainability of cost savings; equity and distributional effects, including effects on employees, consumers, taxpayers and particular groups (eg women and people from a non-English speaking background); the tender process, including how to handle in-house bids to ensure competitive neutrality; and industry and regional development effects.

The Commission has focused on issues generically rather than on individual activities. This includes looking at how the success of contracting is affected by different service characteristics (eg the difficulty in measuring output, high risk and the cost of failure) and different market characteristics (eg the extent of competition).

Even its most ardent supporters acknowledge that the CTC experience has been uneven. There have been failures as well as successes. Against this background, the Commonwealth Government, in consultation with the states and territories, asked the Commission to inquire into contracting out by public sector agencies, with a view to suggesting measures which could promote its more cost-effective use.

A1.3 The Commission's approach

In reporting on the matters under reference, the Commission was asked to have regard to the established economic, social, environmental, public administration and regulatory reform objectives of governments. While the Commission has taken an economy-wide view, looking to the wider interests of the community as a whole, it has also sought to identify and address any particular effects on individual groups, notably employees, consumers, women and people from a non-English speaking background, and the effects on rural and remote areas.

The Commission has not sought to identify particular services which should be competitively tendered or contracted out. Instead, it has used case studies and particular examples to examine key issues and develop policy recommendations. In doing so, however, the Commission has been mindful of important differences between activities.

The Commission has attempted to further the CTC debate by:

- providing information on the extent of CTC and the policies governments have adopted towards it;
- critically examining the experience to date in contracting to derive key success factors;
- making recommendations on the broad policy framework; and
- providing guidance to practitioners on best practice in CTC.

The Commission has not examined ‘what’ services government should ensure are provided. Rather, it has focused on ‘how’ services can best be delivered once decisions have been made by government on what should be provided and on the quantity and quality (including any Community Service Obligations) to be provided. The Commission has examined CTC as one among a range of options.

In compiling this report, the Commission has drawn heavily on the material and views presented by a large number of people through submissions, public hearings and visits. The Commission is grateful for this participation. Details of the participation in, and conduct of, the inquiry are at appendix A.

The Commission has undertaken some original research including a study of F111 maintenance at the Amberley RAAF base, and has commissioned a survey of CTC by Commonwealth Government budget sector agencies. It has also built on its own reports into *Impediments to Regional Industry Adjustment*, *Defence Procurement*, *Charitable Organisations in Australia*, and *Computer Hardware, Software and Related Industries*.

The Commission has drawn upon, but not duplicated, other relevant studies such as that of the Information Technology Review Group (1995) for the Commonwealth Minister of Finance, the Economic Planning Advisory Commission Task Force *Interim Report on Private Sector Involvement in Public Infrastructure* (EPAC 1995), the Joint Committee of Public Accounts report into Commercialisation in the Australian Public Service (1995a), the Report by the House of Representatives Standing Committee on Industry, Science and Technology, *Australian Government Purchasing Policies: Buying our Future* (1994) and the Report of the Committee of Inquiry into Australia’s Standards and Conformance Infrastructure (Kean Report 1995).

A1.4 Structure of the report

This report is divided into three main parts.

Part A comprises this chapter and chapter A2 which documents the extent of CTC.

Part B examines the evidence of the effects of CTC on a range of variables and stakeholders. Drawing on a variety of experiences, it attempts to identify those factors influencing the success or failure of CTC. The issues examined include accountability (chapter B1), the effect of contracting on service quality (chapter B2), the costs of service provision (chapter B3), employment, wages and conditions (chapter B4), social and distributional effects (chapter B5), and industry and regional development (chapter B6).

Part C examines ways to improve the cost-effectiveness of CTC, drawing on those key factors identified in part B. This commences in chapter C1 by identifying the broader impediments to CTC deserving attention. Chapter C2 examines CTC from a whole-of-government perspective and suggests some broad policy approaches. Strategic approaches to CTC from an individual agency's perspective are examined in chapter C3.

The following chapters focus on various aspects of the CTC process. Chapter C4 looks at ways to promote effective competition and chapter C5 examines in-house bids. Chapter C6 develops some 'best practice' guidelines for managing the tender process from contract specification to contract award, while chapter C7 examines mechanisms for monitoring performance. Managing human resources under CTC is the subject of chapter C8. Chapter C9 examines the transitional issues associated with implementing CTC and identifies the next set of issues which may emerge.

The analysis in the main body of the report is supported by a number of appendices. They include a detailed description of current Commonwealth, state, territory and local government policies on CTC (appendix B), the survey of CTC by Commonwealth Government budget sector agencies (appendix D) and the quantification of the economy-wide effects of CTC (appendix G).

A2 THE EXTENT OF COMPETITIVE TENDERING AND CONTRACTING OF SERVICES

A2.1 Introduction

The inquiry's terms of reference ask the Commission to report on the nature, extent and scope of competitive tendering and contracting (CTC) by Commonwealth, State and Territory, and local governments and their agencies.

This chapter examines the present use of contracting¹ by governments in Australia, and its growth over time. It also draws on developments in the private sector and overseas.

The chapter addresses the range of services that are currently contracted. These include services provided to government for internal use and those provided directly to the public. The factors that should be taken into account when determining the scope for contracting are addressed in chapter C3.

This chapter also looks at the various types of contractors that are employed by public sector agencies, including private and not-for-profit organisations, other governments agencies and in-house teams.

The data on contracting is far from comprehensive — most studies focus on particular types of contracting, and there is little data available for many jurisdictions.² In addition, while recent data is available for the Commonwealth and several states, data for local government contracting (except in Victoria) is outdated.

To improve the data base the Commission had a survey undertaken of Commonwealth budget-funded agencies.³ The survey was designed to obtain data broadly consistent with that available for New South Wales, Victoria and

¹ While the focus of this inquiry is on CTC, much of the available data includes expenditure under non-competitively tendered contracts. To deal with this problem, the term contracting is used throughout this chapter to refer to all contracts for service provision, including competitively tendered and non competitively tendered contracts.

² In particular, little data is available on the extent of CTC by public sector agencies in Queensland, South Australia, Tasmania, the Australian Capital Territory and the Northern Territory, and by Commonwealth Government Trading Enterprises (GTEs).

³ The survey was undertaken by the CTC Research Team at the Graduate School of Business, University of NSW.

Western Australia. The results of the survey are presented briefly below, and more fully in appendix D.

A2.2 What is the extent of contracting?

While both goods and services are contracted by public sector agencies, the focus of this report is solely services.

The extent of contracting can be measured in several ways, including by the absolute amount of expenditure incurred through contracts, by the proportion of total expenditure incurred through contracts, and by the number and proportion of public sector organisations using contracting.

Whatever measure is used, comparisons between the extent of contracting by different governments or agencies must be treated with caution. The surveys on which the comparisons are based cover different types of contracting and vary in the minimum value of contracts included.⁴ In addition, the data available for each jurisdiction often refers to different years: an important qualification when the use of contracting appears to be changing quickly.

Another point worth noting is that, while construction services have been widely contracted for many years, they have been excluded from recent surveys of state governments and, for comparability purposes, from the Commission's Commonwealth survey. However, construction services are included in local government estimates.

Thus, while the figures presented in this section are the best available indication of the extent of contracting by governments and agencies, in most cases they are only roughly comparable.

A2.2.1 Contracting by level of government

The broad picture which emerges from the available data, is that:

- based on the Commission's survey⁵ and additional information from the Department of Defence submission (Sub. 81), at least \$2.2 billion of Commonwealth budget sector current expenditure was contracted in 1994-

⁴ Most studies focus on the extent of contracting out and therefore exclude contracting with in-house teams. Some studies also exclude contracts awarded to other government agencies.

⁵ The Commission received valid responses to the survey from 43 of the 126 Commonwealth budget sector agencies it was sent to.

95, excluding construction services.⁶ If it were assumed that the same proportion of expenditure was contracted by the rest of the Commonwealth budget sector (ie 15 per cent), total Commonwealth budget sector contract expenditure on services would have been around \$4.5 billion, excluding construction services. This compares with expenditure on newly gazetted contract services which, excluding construction, was \$3.2 billion in the same year.⁷ If the same proportion of expenditure on services (ie 15 per cent) was contracted by the non-budget sector as well,⁸ total Commonwealth public sector expenditure on contracting would be in the region of \$8 billion (excluding construction services);

- based on state government survey data, New South Wales, Western Australia and Victoria together spent at least \$1.8 billion on contracted services (excluding construction services) in 1993-94. If a similar proportion of current expenditure (ie 4 per cent) was contracted by the remaining states and territories, total state level contract expenditure would have been around \$3.3 billion in the same year; and
- little up-to-date data is available at local government level. Victorian councils tendered just under \$500 million of work in 1994-95, with almost all councils reaching the required minimum target of tendering 20 per cent of total expenditure (Victorian Office of Local Government 1995). If 20 per cent of total current local government expenditure was contracted Australia-wide, contracting of services at local level would be in the vicinity of \$1.5 billion to \$2 billion.

In addition to formal contracting, Commonwealth, State and Territory Governments also provide significant funding to community organisations under non-contractual arrangements, though no accurate data is available on this matter.

It should also be noted that the above estimates do not include the procurement of goods. The combined procurement bill of Commonwealth, State and Territory Governments for goods and services was approximately \$30 billion in 1992 (Bolkus 1992).

⁶ This figure excludes, in particular, contract expenditure on goods, capital works, construction projects and contracts of less than \$50 000 (unless they could be aggregated with like contracts), as these were omitted from the survey.

⁷ Gazetted contracts may be of any duration, and hence cannot be used to construct an annual expenditure figure. However, if it is assumed that expenditure on gazetted contracts is relatively stable over time, the figure provides a rough guide of total contract expenditure.

⁸ No recent data is available, precluding a more accurate assessment of the extent of contracting by Commonwealth GTEs.

Moreover, the observed differences in the extent of contracting at different government levels may partly be the result of differences in the functions of different levels of government. In addition, estimates at state level are based on surveys which excluded contracted services which were not tendered.

As in Australia, contracting is being used at different levels of government in other countries (see box A2.1).

Box A2.1: Extent of contracting in other countries

In the UK, compulsory competitive tendering (CCT) applies to a range of services provided by central and local government. Around £946 million of central government department expenditure on services, £900 million of National Health Services expenditure, and £3 billion of local authority expenditure on services were allocated through competitive tendering by 1986-87. These figures appear to have increased significantly since, in part due to the extension of the government's Competing for Quality program and CCT. By 1995 £1651 million of central government expenditure on services had been subject to competitive tendering, while at local level, approximately £6 billion of local authority services were subject to CCT in 1993.

In the USA, approximately \$US 200 billion of Federal Government work, and \$US 100 billion of state and local government work was contracted out by 1987. The average city contracted out 27 per cent of its municipal services.

The Canadian Federal Government contracted out \$Can 5.2 billion worth of services in 1992-93.

Sources: Canadian House of Commons 1994, Osborne and Gaebler 1993, Confederation of British Industry 1988, Department of the Environment 1993, Citizens Charter 1995a.

A2.2.2 Commonwealth agencies

From the Commission's survey undertaken for the inquiry and from information in submissions, it appears that most contracting of services within the Commonwealth budget sector takes place in the largest departments⁹:

- Defence is the greatest user of contracts for service provision at Commonwealth level. Contracts for services amounting to almost \$1.5 billion were gazetted in the first half of 1994-95 (including \$1.1 billion on construction and construction services) (Sub. 81);

⁹ While estimated contract expenditure figures are presented for agencies, the proportion of total expenditure contracted in each case is not estimated. Such proportionate figures are likely to be misleading due to the different definitions of contracting used by the agencies.

- the Department of Veterans' Affairs is the next largest contracting department, letting \$825 million of contracts for services in 1994-95 (IC survey);
- the Department of Employment, Education and Training (DEET) let \$303 million of contracts for services in 1994-95 (IC survey);
- AusAID signs approximately \$170m of new contracts each year for the development and implementation of projects, and around \$1-\$1.5m of contracts for administration purposes (Sub. 47);
- the Department of Administrative Services (DAS) let \$151 million of contracts for services in 1994-95 (IC survey); and
- the Department of Social Security let \$134 million of contracts for services in 1994-95 (IC survey).

In the non-budget sector, Commonwealth Government Trading Enterprises (GTEs) are also extensively involved in CTC, though no recent aggregate figures are available.

A2.2.3 State and Territory Governments

Contracting is used by all State and Territory Governments. The most recent estimates indicate that contracted expenditure accounted for at least \$1 billion in the New South Wales public sector in 1993-94 and just over \$670 million in the Western Australian public sector in 1994-95 (see table A2.1). While no figure is available for contracting in the whole of the Victorian public sector, in the budget sector it accounted for at least \$340 million in 1993-94 (Sub. 215).¹⁰ Aggregate data for other states and territories is unavailable.¹¹

Contracting accounted for around 7.6 per cent of current expenditure in the Western Australian public sector in 1994-95, and around 4 per cent in the New South Wales public sector in 1993-94. In Victoria, contracting accounted for around 3.5 per cent of current expenditure in the budget sector in 1993-94.¹²

¹⁰ The Victorian survey excluded the Health and Community Sector, in-house contracts and contracts not competitively tendered.

¹¹ Data for South Australia may be available from the inquiry into outsourcing by the Economic and Finance Committee of the Legislative Council of South Australia upon completion.

¹² The Victorian figure includes an estimate of contract expenditure by the Department of Health and Community Services and was provided by the Victorian Government (Sub. 289).

As at the Commonwealth level, CTC is widely used by both budget and non-budget sector agencies at state level. For example, disaggregating the figure presented in table A2.1, in NSW in 1992-93 the budget sector contracted around \$430 million of services, while the ten major GTEs contracted around \$100 million. Disaggregation of the NSW 1993-94 figures, or those for Western Australia is not possible.

Table A2.1: Contracting of services by New South Wales and Western Australian public sector agencies

	<i>Expenditure contracted (\$ million)</i>			<i>Expenditure on contracted services as a proportion of total current expenditure (%)</i>		
	<i>1992-93</i>	<i>1993-94</i>	<i>1994-95</i>	<i>1992-93</i>	<i>1993-94</i>	<i>1994-95</i>
NSW	535 ^a	1064 ^a	na	2.3	4.0	na
WA	284 ^b	365 ^c	671	3.6	4.0	7.6

a Consultancies were specifically excluded from the NSW surveys.

b Contracts for Construction and Other services (including purchasing and supply) have been excluded to be consistent with the other figures presented in the table.

c Survey excluded contracts with in-house teams and other government agencies.

Sources: Domberger, Farago, Hall and Li 1993, Domberger and Farago 1994, Independent Commission to Review Public Sector Finances, Western Australia 1993, Farago, Domberger, Hall and Li 1994, Farago, Hall and Domberger 1994, ABS 1994a and 1995b, Domberger, Hall and Skinner, 1995.

In NSW, the agencies with the highest value of contracted services in 1993-94 were the Department of Transport (including the State Rail Authority), the Department of School Education, the TAFE Commission, the Department of Housing and the Health Department. In Western Australia in 1994-95, the greatest users of contractors were the Health Department, the Department of Conservation and Land Management, the Department of the Premier and Cabinet, the Disability Services Commission and the Education Department. Detailed figures on contracting agencies in Victoria are not available.

Though no aggregate figures are available for other states and territories, contracting is used in the provision of a range of services in these jurisdictions.

In Queensland, services currently outsourced include hospital services such as nursing and radiology, road maintenance and construction, management and operation of prisons, and management and operation of significant information technology (IT) functions (Sub. 162).

In South Australia, the Department of Building Management outsources all construction activity and 40 per cent of maintenance services, while the Department for Family and Community Services spends between 35 and 40 per

cent of the recurrent budget on external service provision. Other services contracted include a range of hospital services, IT and correctional services (Sub. 123). The State Government has also received tenders for the provision of its IT infrastructure and for the operation and maintenance of Adelaide's water supply and sewerage systems, while it plans to tender for the management of its telecommunications systems.

In Tasmania, contracts have been let for the provision of a range of human services, hospital facilities, funds management, legal advice, repair and maintenance of technical equipment, telecommunications, computer services, cleaning and items of that nature (Transcript, p. 1289 and Sub. 108).

In the Northern Territory, contracting is used for services ranging from auditing, mapping, aerial photography and the maintenance of roads and airstrips to the operation of power and water in Aboriginal communities and emergency road works. An estimated 40 per cent of all printing requirements are outsourced, as are 50 per cent of urban public and school bus services.

In the Australian Capital Territory, competitive tendering is used by a range of departments. Services competitively tendered include waste management, capital works design and construction, traffic and stormwater services, information technology and certain nursing services (Sub. 266). Police services are contracted to the Australian Federal Police.

A2.2.4 Local government

The vast majority of Australian councils use CTC in some form. In 1989, 87 per cent of councils contracted at least one service, with 52 per cent contracting more than four (Evatt Research Centre 1990).

While aggregate expenditure figures on CTC are not available for most states, studies suggest that around 10 to 20 per cent of total council expenditure was contracted out by the early 1990s (see table A2.2). Information from inquiry visits, submissions and public hearings suggests that this is likely to be a considerable underestimate of the extent of contracting now undertaken.

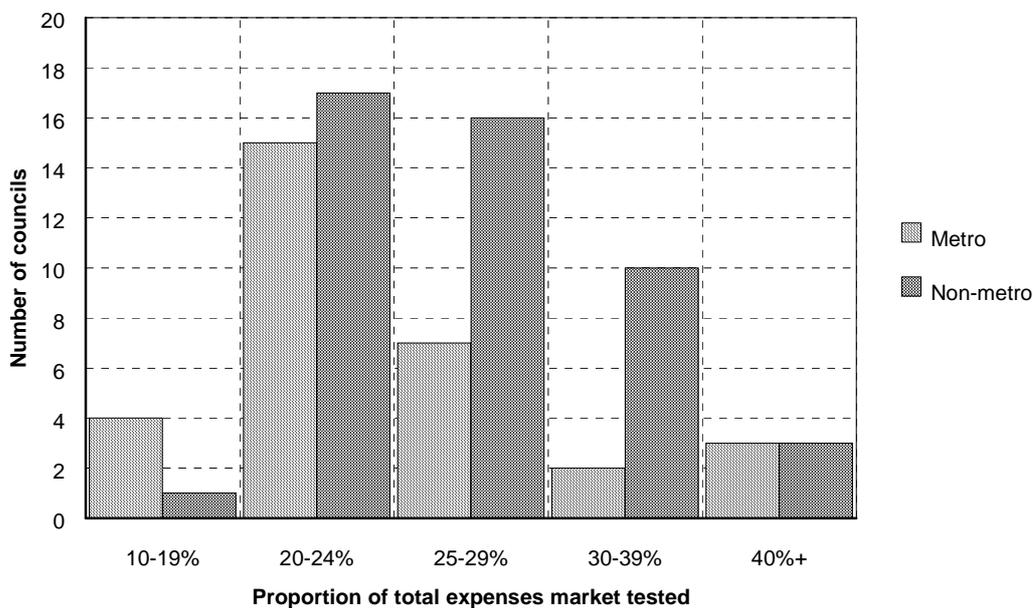
In the case of Victoria, councils are required to have competitively tendered at least 20 per cent of total expenditure in 1994-95, increasing to 30 per cent in 1995-96 and 50 per cent in 1996-97. Of the 78 Victorian councils, all but 5 reached the 1994-95 target, with many exceeding it (see figure A2.1). Councils outside Melbourne achieved slightly higher levels of contracting than metropolitan councils.

Table A2.2: Local government expenditure through contracting^a

Year	Jurisdiction	Study	Expenditure contracted as a proportion of council expenditure (%)	Total expenditure through contracting (\$m)
1988-89	Australia	Rimmer 1991a	18 ^b	916
1990-91	Victoria	MAV 1993	7 ^c	-
1991-92	Victoria	MAV 1993	8 ^c	208
1992	NSW	DLGCO 1992	14 ^d	431
1994-95	Victoria	OLG 1995	25	500 ^e

- a Rimmer’s study covered expenditure on goods and services. The studies by the MAV and the Department of Local Government and Co-operatives (DLGCO) excluded expenditure on goods.
 - b Proportion of total current expenditure.
 - c Proportion of total council expenditure (defined as current and capital expenditure plus transfers to reserve funds and debt charges). This figure excludes contracts with other councils.
 - d Proportion of revenue expenditure (excludes capital expenditure). This figure represents all expenditure through external providers (generally non-council labour and other resources), and thus may include negotiated contracts and non-contractual funding.
 - e This figure was based on CCT statements made by all councils, some of which were still unaudited.
- Sources: Rimmer 1991a, MAV 1993, DLGCO 1992, Victorian Office of Local Government 1995 and unpublished data.

Figure A2.1: Competitive Tendering in Victorian Local Government 1994-95



Source: Victorian Office of Local Government 1995

While contracting is used extensively at local government level, there is enormous variation in its use by individual councils. For example, in New South Wales in 1992, Jerilderie Council used no contracting while Holroyd City Council contracted 60 per cent of revenue expenditure. Submissions to this inquiry indicated that councils which contract over 40 per cent of total expenditure include Yankalilla in South Australia, Calliope in Queensland, and Launceston in Tasmania (Subs. 119, 15 and 29 respectively).

Box A2.2: Contracting — a metropolitan and rural practice of councils of all sizes

Contracting is employed extensively by councils in regions as different as Penola (South Australia), Calliope (Queensland), Launceston (Tasmania) and Melbourne (Victoria).

Penola is a rural district on South Australia's south-eastern border with Victoria. The Council administers a population of 3600, with a total expenditure of \$2.6 million in 1994-95. In 1993-94, the council contracted out 25 per cent of total expenditure (Sub. 127).

Calliope is a rural shire on the coast just south of Rockhampton, with a population of around 12 000 people. Total council expenditure was \$10 million in 1994-95. Contracting out accounts for 45 per cent of total council expenditure, including services such as technical engineering, debt collection and surveying (Sub. 15).

Launceston is Tasmania's second largest city, with a population of 64 000. The Council's total expenditure was \$54 million in 1993-94, 60 per cent of which was contracted out. Services contracted include animal pound management, street lighting, graphic design, media releases and advertising (Sub. 29).

The City of Melbourne administers one of Australia's busiest cities, with a population of 32 000. Total operating expenditure was \$168 million in 1994-95. The Council is currently market testing around 48 per cent of this expenditure, or \$80 million (Transcript, p. 1456). Services contracted include garbage collection, fleet maintenance and the collection of coins from parking meters.

Sources: as listed, and Information Australia 1995

A2.3 What services are contracted?

A2.3.1 The range of services contracted

A wide range of services has been contracted at all levels of government in Australia. The range extends from defence support services to the delivery of meals-on-wheels (see box A2.3).

Box A2.3: A range of services are contracted in Australia

- Defence support services, including the operation and maintenance of the Defence Satellite Communication Station in Western Australia, and a range of services at the Victorian Puckapunyal camp including firing range management, medical services, fire and emergency services, building and grounds maintenance, catering and cleaning (Serco, Sub. 144).
- Foreign aid: AusAID signs many contracts with external organisations for the development and implementation of bilateral aid projects (Sub. 47).
- Trade development, including the operation by the Australian Chamber of Commerce and Industry of a trade facilitation office in Taipei, and delivery of the Export Access Program to enable small to medium enterprises to develop overseas markets (Sub. 202).
- Mail: nearly all mail delivered outside of metropolitan and urban areas is carried by mail contractors. For over 50 years some two-thirds of Australia Post's retail outlets have been managed by agents under contract (Australia Post 1994).
- Public transport, including the provision of train passenger services on the Melbourne-Warrnambool and Melbourne-Cobram lines in Victoria, the provision of public sector bus services in Victoria and New South Wales, and bus and ferry services in Perth (Sub. 215, Middleton 1995).
- Education, including the writing of policies and guidelines, curriculum and syllabus documents (State School Teachers' Union of WA, Sub. 85 and Australian Education Union, Sub. 33).
- Welfare services, including the delivery of meals-on-wheels, home help, child care and elderly citizens services (Evatt Research Centre 1990 and Holistic Home Care Sub. 70).
- Sanitary services, including the collection of household and other garbage, recycling, sewerage, and public convenience cleaning (Evatt Research Centre 1990).

Contracting is used in the delivery of services both to government and directly to the public. Services provided to government by contractors include auditing, cleaning, maintenance and staff training. Services provided directly to the public by contractors include cleaning of parks and public toilets. Other services are provided directly to individuals, and involve discretion in the allocation of services to produce the desired outcome, such as employment assistance for the unemployed.

Contracting has extended to services which are provided by a variety of trades and professions. For example, road and vehicle maintenance is contracted along with legal services, IT and library services.

Contracting is also expanding into a variety of areas not commonly associated with the practice, such as aged care, policy advising, the management of prisons and emergency services.

Activities of all sizes have been competitively tendered. They include the proposed provision of all IT services to the South Australian Government, and the delivery of meals-on-wheels in small municipalities.

Overseas evidence suggests that Australia is not alone in contracting a wide range of services (see box A2.4).

Box A2.4: Services contracted in other countries

Services commonly contracted internationally include the provision and maintenance of public infrastructure, defence support, community services, refuse collection, IT and protection of the environment.

Other services contracted include bus services in Germany, fire and ambulance services in Denmark, police services in Switzerland, sports centre management in the Netherlands, school meal catering in Italy, security in Japan, the collection of road tolls in Pakistan, and public transport operation in Thailand.

Sources: Domberger and Rimmer 1994, Walsh 1991a, Asian Development Bank 1995, IC 1994a

A2.3.2 Services most contracted

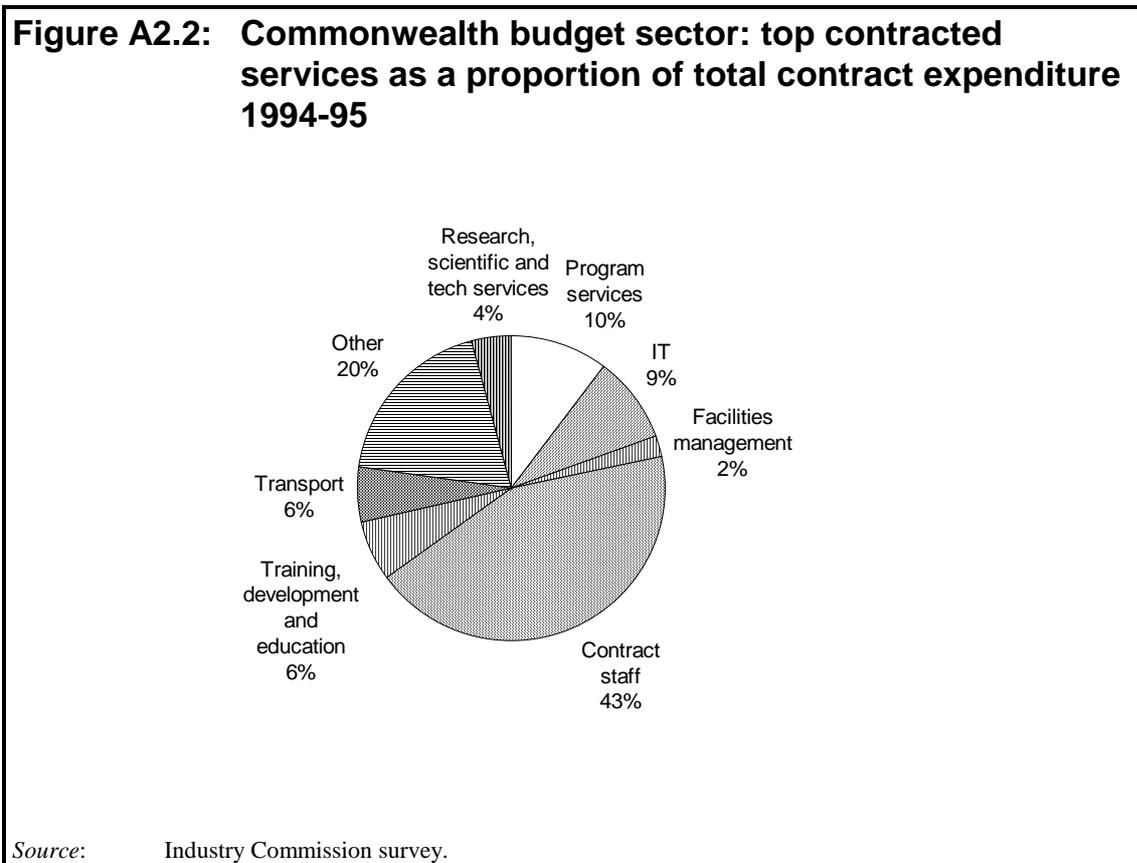
Surveys of Commonwealth and state governments have provided extensive data on the different services contracted at these levels. Surveys conducted at local government level have focussed on the proportion of councils which have contracted each service, though some expenditure data is available.

While many services are contracted at all levels of government, expenditure through contracting appears to be concentrated in a relatively small number of services. In the Commonwealth and Victoria, the top seven services account for over four-fifths of total contract expenditure, while in New South Wales and Western Australia, they account for around three-quarters and two-thirds respectively. While limited expenditure figures are available at local government level, in Victoria the top seven services also represented around two-thirds of total contract expenditure in 1991-92 (MAV 1993).

Commonwealth

In terms of contract value, the services most contracted by Commonwealth budget sector agencies in 1994-95 were contract staff, program services,¹³ IT, training development and education, and transport (see figure A2.2). Construction services are also widely contracted, though they were not included in the Commission’s survey.

The contracts for contract staff and program services were concentrated in a small number of Departments.¹⁴ IT was the service which the most agencies (26 of the 43 respondents) contracted. Other services contracted by at least 18 agencies included research, security, financial management and cleaning.



¹³ Program services include employment and training programs delivered to the public, welfare services, trade development, and registries.

¹⁴ In particular, almost 50 per cent (\$381 million) of the expenditure on contract staff was accounted for by the contracting of health care providers for the operations of the Department of Veterans’ Affairs.

State

At the state level, the top services contracted include building maintenance, transport, IT services, legal services and cleaning (see figure A2.3). Construction is also widely contracted at state level, though it was not included in the surveys sourced below.

While some services are widely contracted across Australia, there is variation between the states, which may be due partly to differences in the services provided in each state.¹⁵ For example, forestry services account for 7 per cent of contracting out expenditure in Western Australia, but under one per cent in Victoria. Equipment maintenance accounts for 9 per cent of expenditure on contracting in New South Wales, compared with less than one per cent in Victoria.

Though no aggregate figures are available for the other states and territories, it appears that CTC is used in the provision of a range of services in these jurisdictions. Services commonly contracted include construction, maintenance and IT services (see A2.2.3).

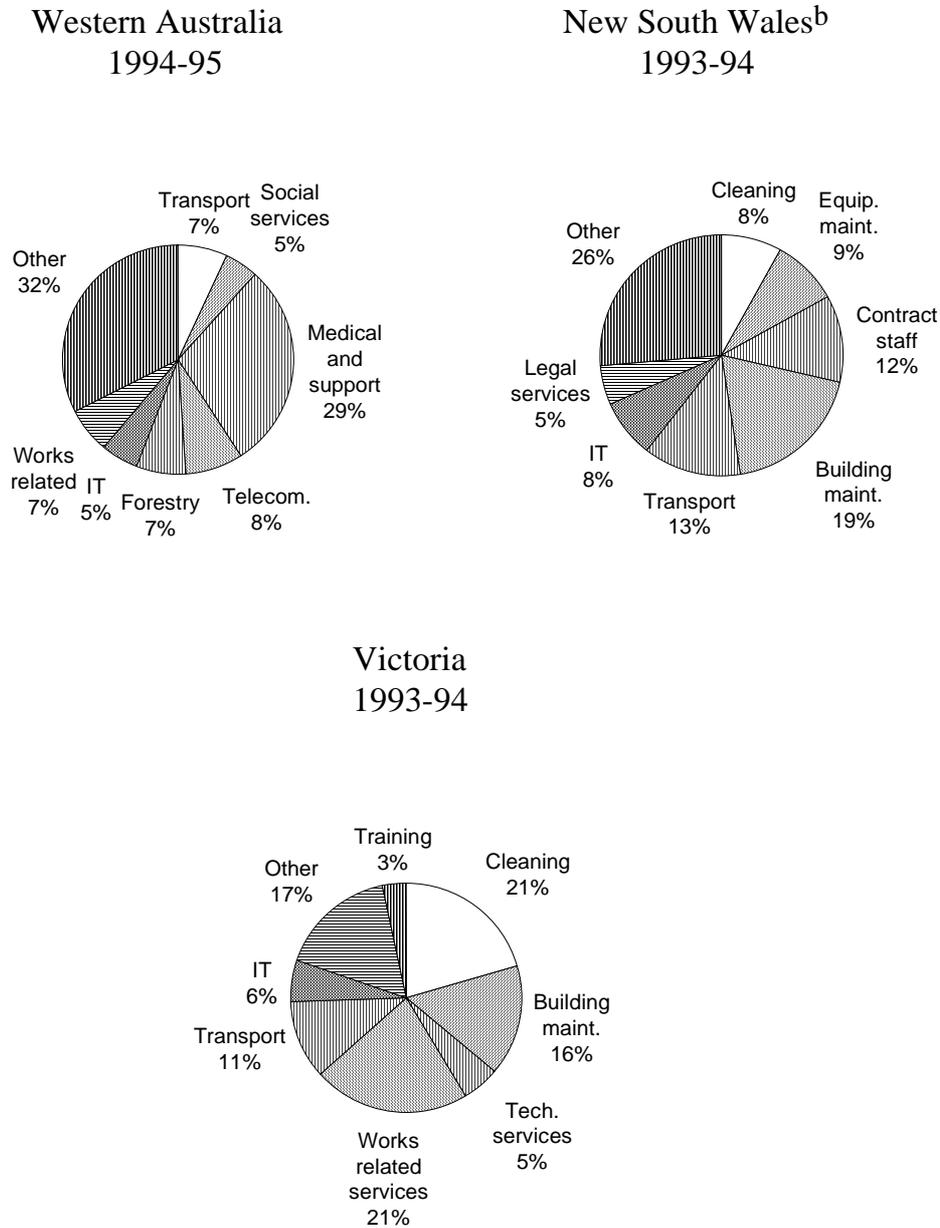
Local

While no recent Australia-wide data is available for local government, a 1990 national survey focusing on services delivered to the public found the most commonly contracted services to be recycling, household refuse collection, sanitation, cleaning of community facilities and maintenance of roads and bridges (see figure A2.4). Services that are contracted, but less commonly, included welfare services, such as child care centres, senior citizens centres, services for people with disabilities, and social work.

Other surveys have also found many services delivered to local councils to be commonly contracted out. For example, in Victoria in 1991-92, the servicing of office equipment, valuations and cleaning of council premises were among the top ten services contracted. Others commonly contracted in several states include research, managerial functions, administrative, engineering and planning services (see MAV 1993, Local Government Association of Queensland, Sub. 35, ACC 1988).

¹⁵ While it appears from figure A2.3 that social services and medical and support services are more extensively contracted in Western Australia than in New South Wales and Victoria, this is largely due to the fact that medical and social service contracts with non-government organisations were only included in the Western Australian survey.

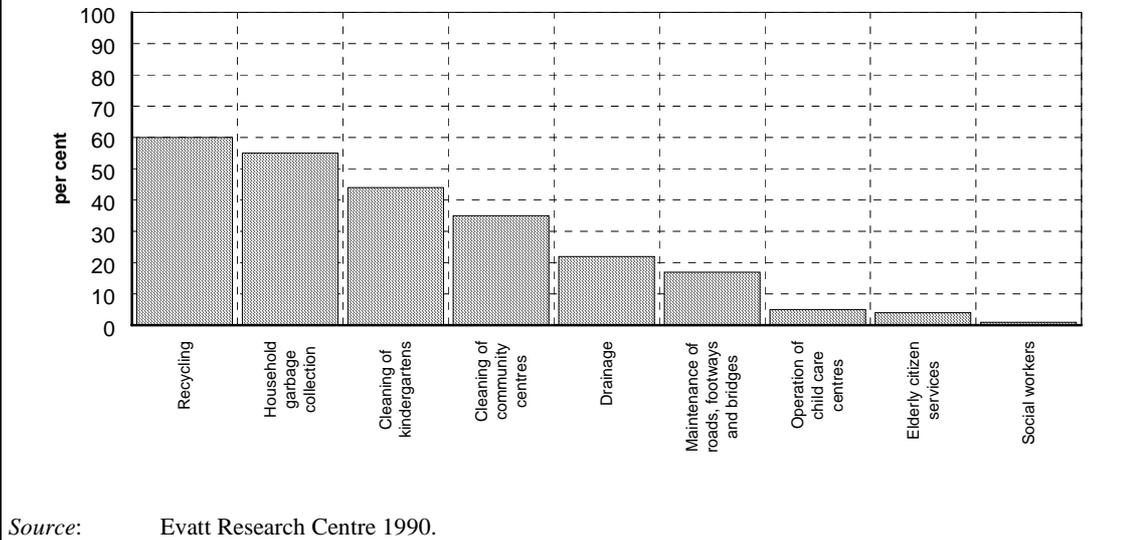
Figure A2.3: State governments: top contracted services by value (as a proportion of total contract expenditure)^a



a WA and NSW figures are for budget and non-budget sectors combined. Victorian figures are for budget sector only. The category 'other' combines a range of other service categories identified in the original studies.

b Forestry figures not available for NSW. 'Contract staff' category was not used in the other surveys.

Sources: Farago, Hall and Domberger 1994, Domberger, Hall and Skinner 1995 and Victorian Government, Sub. 215.

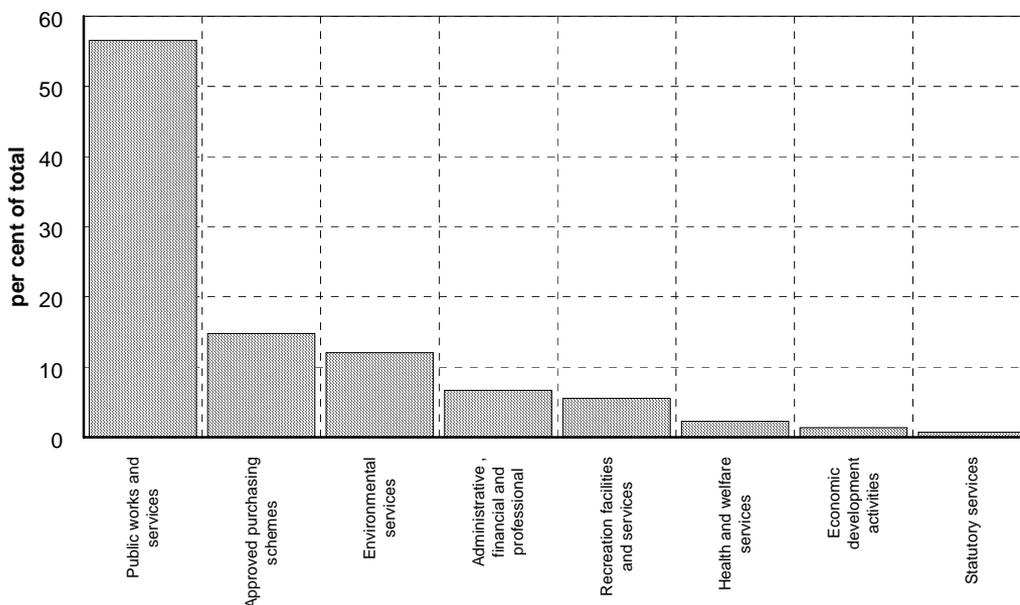
Figure A2.4: Proportion of councils contracting out selected services 1989-90

More recent data is available on the Victorian local government experience under the first year of CCT (see figure A2.5). In 1994-95, over half of CCT expenditure was on public works and services, including construction and maintenance of roads, drainage, and public facilities. The next largest area of expenditure was through approved purchasing schemes¹⁶. However expenditure through such schemes was concentrated on goods such as motor vehicles and fuels, with little contracting for services. Environmental services were also extensively tendered, including garbage collection, recycling and street cleaning.

There is some evidence that the type of services contracted by municipalities can vary considerably, depending on the size of the population. Smaller rural councils typically contract out professional services such as valuations, engineering and planning services. Metropolitan councils are more likely to contract out recycling, construction and maintenance of roads and buildings (MAV 1993, Evatt Research Centre 1990, Local Government Association of Queensland, Sub. 35).

¹⁶ Expenditure made through approved purchasing schemes may be included by councils in CCT expenditure figures. Approved schemes use competitive processes to select suppliers.

Figure A2.5: Victorian local government CCT expenditure by category 1994-95



Source: Victorian Office of Local Government 1995 and unpublished data

Comparison between government levels

Some services appear to be commonly contracted across all levels of government. These include cleaning, IT, construction, maintenance, and technical services such as surveys, planning and engineering tasks. Other activities appear to be contracted more often at certain government levels.

Differences in the functions of each government level, and the service categories used in the above surveys, will account for much of the observed variation in services commonly contracted by Commonwealth, state and local governments. In particular, local government delivers far more of its services directly to the public than state and Commonwealth governments, and thus contracts more of these type of activities.

Even so, based on recent surveys, there are certain services that are provided by several tiers of government that were more widely contracted in some places. For example, training appeared to be more extensively contracted by

Commonwealth agencies than by state agencies. Conversely, legal services were more commonly contracted at state level.¹⁷

A2.4 General trends in contracting

Contracting by public sector agencies for the delivery of services is not a new phenomenon: it has been used for many years (see box A2.5). For example, elements of mail delivery have been contracted out since it was introduced in Australia, while local governments have contracted services including refuse collection and road maintenance since the turn of the century.

Little time series data is available, however, on the use of CTC before the 1990s. At local government level, there was a steady rise in the proportion of councils using contracting for a range of services between the early 1960s and late 1980s. In New South Wales between 70 and 85 per cent of the councils using contracting for refuse collection, sanitation and maintenance of roads and bridges in 1988-89, had already been doing so by 1975-76, with around 50 per cent doing so by 1961-62 (Rimmer 1993). Some councils adopted CTC more rapidly than others. For example, Brisbane City Council's expenditure through contracting out increased fourfold between 1985-86 and 1987-88 (ACC 1988).

At other levels of government, long-term trends in contracting are harder to identify. At the Commonwealth level, there is no clear evidence on the use of contracting over the last ten to twenty years. Total expenditure on consultants reported by departments was 24 per cent higher in real terms in 1993-94 than nine years earlier, though expenditure appeared to peak in 1990-91, and fluctuated significantly over the period. However, when the AusAID and DAS figures are excluded, expenditure by other agencies is seen to have increased by over fourfold in real terms over the nine year period, with a steady trend observable (Howard 1995).

In the early 1990s, there was a sharp rise in the use of contracting in many jurisdictions. For example, in the New South Wales Government, contracting expenditure grew by around 45 per cent from 1992-93 to 1993-94. Defence expenditure through contracting also rose sharply, with the value of service contracts gazetted increasing from \$0.5 billion in 1992-93 to almost \$1.5 billion in the first half of 1994-95 (Department of Defence, Sub. 81). The value of

¹⁷ Legal services at the Commonwealth level will be increasingly subject to CTC following the opening to competition of many services of the Attorney General's Department after July 1995 (see A2.4).

gazetted service contracts let by the Commonwealth budget sector as a whole increased fourfold between 1991-92 and 1994-95.¹⁸

Box A2.5: Contracting is not a new phenomenon

Contracting was commonplace, albeit not without its problems, in 18th and 19th century England. Services provided by the private sector under contract included prison management, road maintenance, the collection of public revenue and refuse collection. Street lamps were made, fixed, cleaned and lit under contract. Early convict fleets, including the First Fleet which left Portsmouth in 1787, were also operated by private contractors. Similarly, in early 19th century France the rights to build and operate railways and water storage and distribution facilities were auctioned by competitive tender.

There are also early examples of contracting in Australia. Contracting of mail delivery and postal services goes back over 150 years. The carriage of mail was entrusted to private operators prior to the formation of Australia's official mail delivery network. New South Wales also had a comprehensive system of privately managed public turnpikes in the 19th century.

Sources: Sturgess 1994, Rimmer 1994, Post Office Agents Association Limited Sub. 39, Domberger and Rimmer 1994.

A similar picture emerges in the Commission's survey of Commonwealth budget-funded agencies: around 80 per cent of their service contracts were let for the first time in the last four years.

In addition to the increases in CTC indicated by this data, sharp rises in contracting in the mid 1990s can be expected in some jurisdictions from government policy initiatives encouraging CTC — in particular, the introduction of CCT in local government in Victoria in 1994-95, and the strong push for CTC by the Western Australian Government since 1994 (see appendix B).

While the use of CTC appears to be growing in some jurisdictions, the nature of services contracted has also been changing. Contracting has expanded from services such as refuse collection and cleaning to areas sometimes seen as core government activities.

Prison management and operation is a good example. The first prison privately managed under contract, Borallon Correctional Centre in Queensland, was opened in 1990. A further three privately managed prisons have been opened: Arthur Gorrie Remand and Reception Centre in Queensland; Junee in New South Wales; and Mt. Gambier in South Australia. The contract for the

¹⁸ MAB-MIAC 1992 and AGPS unpublished data. Note these figures may also reflect increasing departmental compliance with gazettal requirements over time.

operation of Woodford prison in Queensland (due to be completed in 1997) was won by the Queensland Corrective Services Commission under a competitive tender in 1995. Victoria has contracted out the operation of a prison in Deer Park (due for completion by mid 1996), selected a preferred tenderer for a prison in Sale, and plans to competitively tender the operation of a further prison in North Laverton (Sub. 154 and Sub. 215).¹⁹

Another service which has recently been contracted is employment assistance for the long-term unemployed. The Employment Services Regulatory Authority (ESRA) was established in 1994 by the Commonwealth Government to accredit and contract private organisations for the delivery of employment assistance to long-term unemployed people. ESRA will competitively tender services to 20 per cent of the job seeker case management market in 1995-96, increasing to 30 to 40 per cent in 1996-97 and beyond, depending on evaluation of the capacity and effectiveness of contracted case management (Sub. 278).

In 1993-94, over \$500 million of Labour Market Program services were contracted out. This included delivery of the Landcare and Environment Action Program (LEAP) and JobSkills programs, under which employment experience and training are provided to young and long-term unemployed people respectively (Sub. 230). DEET also contracted with managing agents to arrange just over 90 per cent of New Enterprise Incentive Scheme placements, assisting eligible unemployed people to establish and operate viable small businesses.

There are examples of contracting hospital services in most Australian states. Respective state governments have contracted out the management of the Port Macquarie and Hawkesbury Hospitals in New South Wales, the Mersey Hospital in Tasmania, and the Modbury Hospital in South Australia. The Commonwealth Department of Veterans' Affairs now purchases services from Hollywood and Greenslopes Hospitals in Western Australia and Queensland respectively. The Victorian Metropolitan Ambulance Service currently contracts ex-ambulance officers to undertake non-emergency work, and has contracted out the operation of the central communications control room (ACTU, Sub. 75). Other health services being provided to the public on a contract basis include pathology, radiology and obstetrics (Australian Medical Association, Sub. 63).

Contracting has also extended to services which agencies at certain levels of government were previously restricted from contracting. For example, the contracting of legal services by Commonwealth departments and agencies will significantly increase from 1 July 1995. From that date they have been able to

¹⁹ Other ancillary correctional services are contracted out in Victoria, including prisoner transport, security in hospital security wards, and security of cells at the Magistrates and Supreme Courts.

purchase from the private sector some of the legal services previously provided solely by the Attorney-General's Legal Practice (and valued at around \$55 million) or provided in-house (Attorney-General's Department, Sub. 175).

Comparing trends in public sector contracting with those in the private sector is a difficult task. As for public sector agencies, there is little time series data available on the use of contracting by private companies. There is, however, some evidence on the use of contracting in particular industries, or in particular activities. A recent survey of large manufacturing firms conducted by the Bureau of Industry Economics (BIE) found that, in most cases, contracting rose as part of a global trend in the mid to late 1980s, that many activities have now been contracted for a considerable time, and that there was little increase in outsourcing in this sector in the early 1990s (BIE 1994a).

Outsourcing is now used in a variety of private industries. Examples include the five year outsourcing contract signed in 1994 between Macquarie Bank and IBM for the management of the bank's computer operations, the management of the supply system at the Caltex petroleum refinery at Kurnell in Sydney by Serco, and the management and maintenance of Shell Australia's telecommunications infrastructure by Telstra. It is estimated that Australian companies currently outsource \$5.5 billion of accounting activities alone, or 10 per cent of accounting expenditure. This figure has been projected to grow to \$27 billion, or 30 per cent within ten years (IBIS 1994).

A2.5 Who are the contractors?

Competitive tenders may be won by private contractors, not-for-profit organisations, other government agencies or the tendering agency's own in-house teams. Bidding for contracts by in-house teams does not appear common in most Commonwealth and state agencies, while there is little information on this matter in local government. From the evidence available, it appears that most Commonwealth and state contracts are won by the private sector, as are most external contracts at local government level.

A2.5.1 In-house contracting

On the evidence provided by the Commission's survey, in-house bids were submitted for only about 10 per cent of Commonwealth budget sector contracts in 1994-95 (see table A2.3). While most agencies had few or no in-house bids, agencies which prepared in-house bids included the Department of Defence, DEET and DAS. In-house bids are particularly common in Defence, with a third of the contracts competitively tendered under the Commercial Support Program

in 1994-95 (around 40 per cent in value terms) won by in-house teams (IC survey).

Table A2.3: In-house bids

<i>Jurisdiction</i>	<i>Agencies</i>	<i>Year</i>	<i>Proportion of tenders subject to in-house bids (%)</i>	<i>Proportion of in-house bids that were successful (%)</i>
Commonwealth	Budget sector	1994-95	10	15
NSW	Public sector	1994-95	<1	54
	Budget sector	1993	7	47
	GTEs	1993	10	approx. 40

Sources: IC survey, Farago, Domberger, Hall and Li 1994, Domberger, Farago, Hall and Li 1993, Government Officer 1994

In-house bids appear more common at central government level in the UK than in Australia. Just under 40 per cent (by value) of contracted services there were subject to an in-house bid in 1992-93 and 1993-94.

The most recent estimate suggests that in-house bids are submitted for less than 1 per cent of New South Wales contracts (see table A2.3). Though no figures are available for other states, it was submitted by the South Australian and Victorian governments that in-house bids are also infrequent in these states, and are generally not encouraged. In Western Australia, agencies are now expected to call tenders without inviting an internal bid for those non-core activities for which a strongly competitive market already exists in the private sector (see appendix B).

Where in-house bids are submitted, they appear to have been more successful in New South Wales than in the Commonwealth budget sector. In New South Wales around half of in-house bids submitted have been successful, compared with about one tenth at the Commonwealth level (see table A2.3). By comparison, in the UK, 73 per cent (by value) of those central government services subject to an in-house bid were won by in-house teams.²⁰

There is little data on this aspect at local government level. In-house bids may be more common in Victoria than other states since the introduction of CCT. For example, in the City of Melbourne, around 60 per cent of contracts competitively tendered have been awarded in-house (Transcript, p. 1467). In the UK, 77 per cent of local government services (by value) subject to CCT were won by in-house teams in 1994.

²⁰ This figure refers to those services reviewed under the Government's Competing for Quality program (Citizen's Charter 1995b).

A2.5.2 Contractors

At both the Commonwealth and state levels, the available evidence indicates that most contracts are awarded to the private sector.

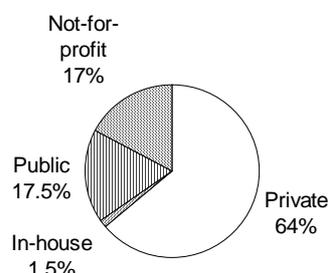
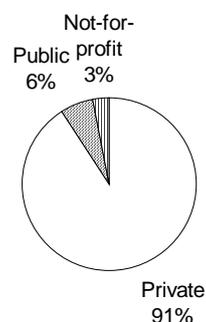
At the Commonwealth level, the Commission's survey of budget sector agencies indicated that in 1994-95, 64 per cent of contracts were won by the private sector, 17 per cent by the not-for-profit sector, 17.5 per cent by other public sector agencies and 1.5 per cent by in-house teams.

Not-for-profit organisations, including local associations, community groups and universities, are contracted by Commonwealth bodies to provide a range of services. For example, the Department of Veterans' Affairs has contracted a Vietnam veterans' counselling service to the Salvation Army. AusAID has used not-for-profit organisations, such as World Vision Australia and CARE Australia, to deliver food aid and emergency assistance in situations of humanitarian crisis, and development assistance in politically sensitive areas (IC 1995d).

At the state level, data on the use of different contractor types is only available for the Victorian budget sector, and excludes in-house contracts. Of those services contracted out in that State in 1993-94, 91 per cent were contracted to the private sector, 6 per cent to other public sector organisations, and the balance to the not-for-profit sector (see figure A2.6) (Frost 1995).

The observed differences in the experiences of Commonwealth and Victorian Governments may partly be the result of differences in the functions of different levels of government. In addition, the greater prevalence of 'contracting' with other public sector agencies at the Commonwealth level is likely to reflect the fact that DAS provides a much larger range of services under 'contract' than the Victorian equivalent. Nonetheless, it appears that private sector contractors win a greater proportion of contracts in Victoria than at the Commonwealth level, while the not-for-profit and public sectors win a greater proportion at the Commonwealth level.

In some jurisdictions, government policy may affect the extent of use of different types of contractors. For example, Western Australian Government policy directs that private sector suppliers should be preferred to bids by other government agencies unless the other government agency has unique expertise, or is the only source of supply.

Figure A2.6: Who wins the contracts?^a**Commonwealth 1994-95****Victoria 1993-94**

a: Victorian chart does not include in-house contracts.

Sources: IC survey and Frost 1995

At the local government level, it appears that the majority of contracts awarded externally are won by the private sector rather than by public sector agencies, including other councils. A 1989 survey of all New South Wales and Victorian councils found that only eight councils had contracts with other public sector organisations (Rimmer 1993). A 1991-92 Victorian survey found that 33 per cent of councils had successfully tendered for private and/or public works, with the practice being more common amongst rural councils (MAV 1993).

Volunteers are little used in formal contracting at local government level. A 1989 survey of contracting out in New South Wales and Victoria covering 13 services, including services for families, children, the aged and people with disabilities, found that only one council contracted to volunteers (Rimmer 1993). However, volunteers appear to play an important role in the non-contractual provision of some local government services. For example, a 1988 survey found that New South Wales local councils used between 33 000 and 100 000 volunteers to provide over 35 local government services, including home nursing, meals on wheels and tourist promotion. This survey also found that the use of volunteers to provide these services appeared to increase during the 1980s (Wynands and Pope 1989).

In addition to legally enforceable contracts, Commonwealth, State and Territory and local governments also fund external organisations to provide human services under service or funding agreements. Non-profit community or charitable organisations deliver more of these services than government or for-profit providers.

A2.6 Conclusion

Contracting has been used by governments for many years. The available evidence indicates that contracting is being widely and increasingly used by all levels of government in Australia, covering a broad range of services. Contracting has been extended to areas previously regarded as 'core' government services. This mirrors the experience of other countries.

At all levels of government in Australia, most external contracts are awarded to the private sector, though other government agencies and not-for-profit organisations play an important role in the provision of some services. At least at the Commonwealth and state levels it appears, from surveys, inquiry submissions and industry visits, that in-house bids are not common.

COMPETITIVE TENDERING AND CONTRACTING BY PUBLIC SECTOR AGENCIES

Part B The benefits and costs of CTC

B1 Accountability

B2 Service quality

B3 The costs of service provision

B4 Employment, wages and conditions

B5 Social and distributional impacts

B6 Industry and regional development

B1 ACCOUNTABILITY

B1.1 Introduction

Accountability is fundamental to good governance in modern, open societies. Australians rightly see a high level of accountability of public officials as one of the essential guarantees and underpinnings, not just of the kinds of civic freedoms they enjoy but of efficient, impartial and ethical public administration. (Management Advisory Board-Management Improvement Advisory Committee (MAB-MIAC) 1993, p. 3)

Using competitive tendering and contracting (CTC) as a tool to achieve its various objectives more efficiently and effectively involves some fundamental re-thinking of how government operates (see chapter A1). CTC is one of many public sector reforms which have focussed on greater accountability for outcomes rather than conformity with procedures. Clarifying government's roles as purchaser and as provider inevitably involves redefining responsibilities and relationships between key stakeholders. And while CTC may provide governments with new options for providing programs and services more cost-effectively, greater flexibility to meet individual needs may also entail more discretion. This raises questions about who is accountable, to whom, and for what. For some, the accountability-related issues such as privacy and discretion are so critical for some public services as to render them unsuitable for CTC.

A key question for this inquiry therefore is how CTC affects accountability. Competing arguments have been presented on the impact of CTC on accountability. It has been argued by some that accountability for service delivery is eroded where services are delivered externally, while others argue that CTC enhances accountability. Given this divergence in views, this chapter identifies and examines the potential impact of CTC on some key components of accountability. It also examines the concerns that have been raised in relation to the protection of personal information following contracting to an external service provider.

B1.2 The concept of accountability

At its core, accountability ... involves: a defined capacity by some person or institution to call an authority into account, in the sense of having to answer for its conduct; a responsible authority or person with a duty to answer and explain such conduct; an agreed language and criteria for judgment; and upward, downward, and outward reporting or answering processes. (Doern 1993, p. 4)

While public accountability was raised by many participants as a key inquiry issue, few attempts were made to develop a framework in which to examine the issue. In part, this reflects the complexity of the topic. The Commission recognises that accountability can be viewed from a number of different (and valid) perspectives, but the discussion here draws on so-called ‘principal-agent’ theory. The theory recognises that most activities are too complicated or costly to do oneself: frequently the ‘principal’ is obliged to hire an ‘agent’ with specialised skills or knowledge to perform particular tasks (Sappington 1991).

The underlying principle of accountability and the key consideration of principal-agent theory is how those whose money is used to finance an undertaking (the *principals*) are able to control the performance of those who act on their behalf (their *agents*) and exercise sanctions when necessary (Smith 1990). In the public sector context, MAB-MIAC observed in similar terms:

It is important to understand that this concept of accountability does not imply simply providing information or answering questions, but includes setting goals, providing and reporting on results and the visible consequences for getting things right or wrong, including rewards or sanctions as appropriate. (1993, p. 13)

In the public sector there are multiple principal-agent relationships. In the first instance, the principals are the citizens who pay taxes and elect governments. These elected representatives are the agents of the electorate. They in turn act as principals when employing public officials (agents) to manage the services. The service deliverer is in turn accountable to management. In the private sector, shareholders (the principals) elect a board of directors (agents) to oversee the management of the company in which they have invested. In turn the directors act as ‘principals’ when appointing management to act as ‘agents’ in the interests of shareholders.

Accountability problems arise where the principal and the agent do not share the same objectives. As the level of discretion provided to the agent increases, the opportunity to diverge from the principal’s interests increases. The challenge for the principal is to design and implement mechanisms or incentives to induce the agent to act in the interest of the principal, rather than pursue its own interests.

To overcome these problems, the principal must be able to exercise sufficient control over the agent. To achieve control it is necessary that:

- for each principal-agent relationship, it is clearly established who is *responsible* for different aspects of the service;
- sufficient *information* is readily available so that the performance of the various principal-agent relationships is transparent; and

- there is the opportunity for *redress* where substandard performance is identified and a capacity for that to be corrected or sanctions to be imposed.

B1.2.1 Existing accountability mechanisms

A variety of institutional mechanisms have evolved to address the principal-agent problem in different situations. These vary between the public and private sectors, between jurisdictions, and between different organisational forms (eg corporate entities, government departments or private firms).

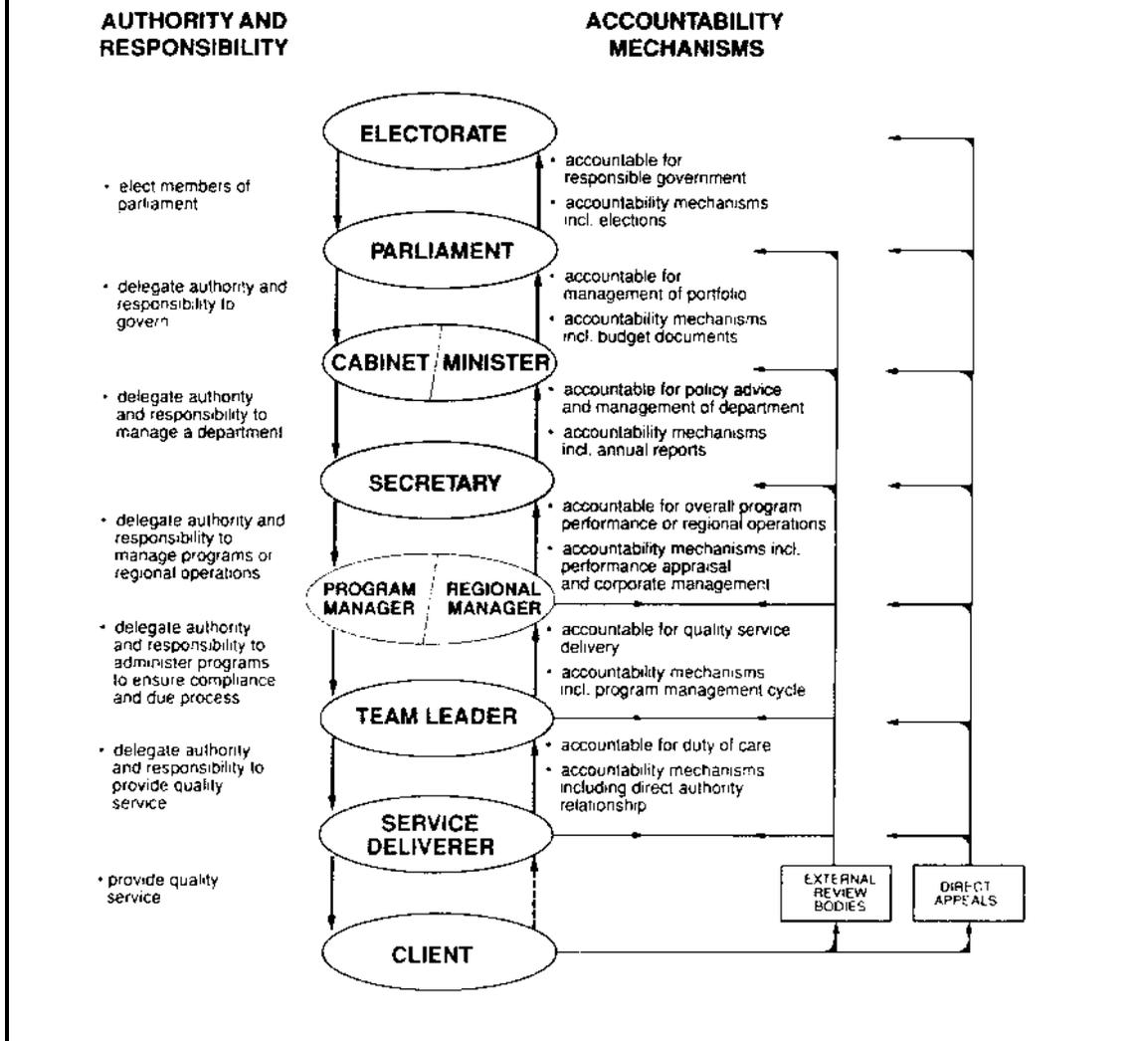
Figure B1.1 illustrates how accountability is addressed in the public sector for government departments. First, it shows the continuum of principal-agent relationships which emerge as *responsibility* to deliver services is delegated. For example, the electorate delegates responsibility to Members of Parliament to govern, who in turn delegate responsibility to Cabinet/Ministers, who delegate responsibility to Secretaries to manage a department, who in turn delegate responsibility to program and regional managers to manage programs.

Second, it reflects the means through which *information* is made available so that elected representatives, officials, individuals and organisations outside government are able to assess the performance of their respective agents. For example, publication of budget documents, annual reports, and program performance statements help to make performance transparent.

Finally, figure B1.1 reveals some of the mechanisms through which affected persons are able to seek *redress* and apply sanctions. For example, clients can make direct appeals or seek redress through external review bodies (eg the courts, administrative appeals tribunals and the Ombudsman) — and, ultimately, at the ballot box.

A number of principal-agent relationships also exist in the private sector. The predominant accountability mechanism is the existence of markets — for products and services, for shares and for managers. Thus shareholders delegate *responsibility* for overall strategic direction of a company to the Board, which in turn delegates *responsibility* for day-to-day operations to managers. *Information* about the relative performance of the shareholders' agents is generally reflected in the share market and in regular financial statements. *Redress* also operates largely through market mechanisms: for example customers can take their business elsewhere, while shareholders can sell their shares.

Figure B1.1: Public service responsibility and accountability framework



Source: MAB-MIAC 1993

The accountability frameworks in both the public and private sectors are continuing to evolve. For example, the traditional hierarchy of the Westminster system has in recent times been supplemented by the advent of new external review bodies (eg the Ombudsman) and greater use of Parliamentary Committees. Similarly, recent changes to the private sector accountability framework include the establishment of new regulators such as the Australian Securities Commission.

In both the public and private sectors there is a mix of government-imposed and market mechanisms for accountability. While there is an ongoing debate about the relative efficacy of the accountability frameworks which apply in the public and private sectors, the key observation here is that CTC inevitably brings a different mix of accountability mechanisms into play. At issue is whether this change enhances or detracts from accountability.

B1.3 CTC and the impact on accountability

Where CTC is introduced, an additional principal-agent relationship emerges. Service delivery becomes the responsibility of another person (which could be a person in the same agency, another public sector agency or a private organisation).

A wide range of views were presented to this inquiry about the impact of this additional relationship on accountability. A number of reasons were provided to support the view that CTC enhances accountability, including:

- it forces agencies to specify clearly the objectives of the service and clarify the responsibilities of the service provider, making it easier to identify who is responsible for different aspects of the service;
- the process of contract specification and the establishment of objective performance criteria make it easier to measure the performance of the organisation delivering the service; and
- as a result of improving the level of information on performance and the opportunity to replace the service provider (or in some instances choose between different service providers), the capacity to impose effective sanctions against non-performers increases.

However, concerns were also expressed that the introduction of a separate service provider reduces accountability because:

- the line of accountability becomes extended and less certain, making it difficult for affected parties to determine who is responsible for the delivery of the service;
- for services where it is difficult to allocate precise responsibility, the introduction of an additional person provides greater scope to shift the blame, making it difficult to seek redress; and
- where services are no longer provided internally, it becomes difficult to safeguard the rights of clients, including the right of privacy and right to scrutinise government decision-making, especially in the absence of the

public sector accountability mechanisms (eg the Ombudsman, Freedom of Information (FoI), and the various appeal mechanisms).

While there were differences of view about many aspects of the impact of contracting on accountability, there was general agreement across all levels of government and among other inquiry participants that, while responsibility to do certain things can be transferred, accountability cannot.

This means that, irrespective of whether an agency delivers the service itself or contracts out all or parts of the service, it remains accountable for ensuring that the required service is actually delivered. Public money is being spent for the provision of the service and the contracting agency is responsible for ensuring that this money is spent effectively and with propriety. In the words of the Johnstone Shire Council (Qld):

The government/agency must be charged with and retain ultimate responsibility for the quality, appropriateness and effectiveness of the service. This will involve a change of emphasis to an administrative, regulatory and policing role. The government/agency must, however, in all circumstances, retain the role of 'principal'. (Sub. 17, p. 1)

Since it remains fully accountable for the exercise of the authority delegated to it by government, the agency's accountability will extend to all the decisions and actions it takes in fulfilling its delegated responsibilities. This will typically involve developing specific programs to meet government policy objectives which may be expressed in very broad terms. It will also encompass decisions and actions the agency takes in specifying contracts, selecting service providers, and monitoring contracts to ensure that the required service is actually delivered.

The Commonwealth Department of Administrative Services (DAS) also observed that accountability extended to all facets of the activity for which it had been delegated authority:

It is important to recognise that contracting out does not allow a government agency to avoid its compliance and accountability obligations by simply taking this step. Nor does it remove the political sensitivities that surround many such transactions. On the contrary, government agencies remain accountable for both contracted out operations and the means by which they are awarded. (Sub. 140, p. 14)

Part of a government agency's delegated responsibility extends to the treatment of clients and the public more generally, on whose behalf the government seeks to act. In the words of MAB-MIAC:

It is now clearly the duty of officials to consider and respond to the needs and aspirations of clients in the administration of programs. Officials are, therefore, accountable to government for the quality of their dealings with clients as well as for the most cost effective achievement of program objectives. (1993, p. 11)

The Commission supports the view that, whatever method of service provision is used, a government agency remains accountable for the efficient performance of the functions delegated to it by government, including:

- **translating broad program objectives into detailed service specifications;**
- **choosing a person (in-house or external) to deliver the service;**
- **ensuring that the service required is actually delivered; and**
- **dealing equitably and responsively with clients and the public.**

B1.3.1 Responsibility for service delivery

In any principal-agent relationship, responsibilities are assigned through either implicit or explicit contracts¹. Traditionally, public sector responsibilities have been assigned through implicit rather than explicit contracts. Moy argued that this leads to a low level of accountability:

While there are implicit elements in most contracts, the public sector has been dominated by implicit contracts. The lack of accountability that results from almost total reliance on implicit contracts is an important factor in explaining the relatively low levels of efficiency observed in public sector provision. (1993, p. 5)

Where CTC is used, the contract is the formal means through which the respective responsibilities of the purchaser and the provider are allocated. Accountability will be enhanced where the contract clearly specifies what the agency and the contractor are responsible for. Where it does, it becomes easier for everyone affected by the service to identify if there has been a failure by:

- the contractor, for not doing what it is required to do in terms of timing, quality, etc; or
- the agency, for not properly specifying what the contractor had to do, selecting an inappropriate contractor, or for ineffectual monitoring of performance.

Some of these aspects were illustrated by the City of Port Phillip:

... the process of exposing services to competitive tendering does not imply that services will cease, nor does it diminish Council's responsibility for managing the provision of services. On the contrary, it encourages Council to clearly articulate its wants, needs and desires through the preparation of specifications. It makes Council

¹ As used throughout this report 'contracts' refer to any agreement between two or more parties, including service agreements where the service is delivered by an in-house team or another agency in the same jurisdiction.

more accountable by showing how it is to measure its success in delivering these services to its community and at what cost. (Sub. 73, p. 5)

On the other hand, it has been suggested that CTC may make it more difficult to meet accountability requirements because it is difficult to allocate precise responsibilities in a contract. In relation to the contracting out of mail services to private contractors by Australia Post, the Commonwealth Ombudsman commented recently:

Commercial contracts may not spell out obligations to the detail of delivering mail without kicking dogs and driving over letter boxes, obviously they do not. In this case, once the buck passing starts in a contractual dispute, one party is obsessed with searching out loopholes while the other side is hell bent on the search for a noose to hang the other side; it is a grubby business and the principle of good service and fair play seem to go out the window. (Smith 1995, p. 7)

The Community Party of Australia observed more generally:

If things go wrong, no one is responsible. (Sub. 84, p. 5)

Difficulties in identifying the responsible person may emerge if there is a failure to allocate all responsibilities in the contract either through oversight or because the characteristics of the particular service make it difficult to do so.

An often cited case of where both the external contractor and the agency were reluctant to accept responsibility, was where a mail deliverer under contract to Australia Post caused damage to a customer's letter box. Both the mail contractor and Australia Post were reluctant to provide compensation to the aggrieved customer. This dispute was resolved after the Commonwealth Ombudsman intervened. It reflects the problems that occur if responsibilities are either ill-defined in the contract or, as has been suggested by the Commonwealth Ombudsman (Sub. 243), where one or both parties are reluctant to accept their contractual responsibility. Where services are contracted out, not only may consumers be unclear as to whom is responsible for the efficient delivery and quality of the services, but the contractors may also be unclear about their rights and responsibilities when undertaking the delivery of services on behalf of a government agency. Thus it is important that contracts clearly establish the responsibilities of each party.

For those services where it is difficult to specify the service required, as it is where the clients' future requirements are unknown, it may be difficult to allocate precise responsibilities. As suggested by the Australian Medical Association:

In circumstances where it is difficult to specify not only the number of services which need to be provided under a contract but the standard to which they need to be

provided, there will always be a difficulty in allocating precise responsibility. (Sub. 63, p. 3)

This difficulty does not necessarily preclude the use of contracting. If it is difficult to specify responsibility in a contract, it will be difficult to allocate responsibility regardless of the way the service is provided. As long as the performance of the service provider and the agency is transparent, and clients are able to seek redress where they are dissatisfied (see below), accountability will not be undermined

Furthermore, where responsibilities are unclear, contracts can be amended to clarify any concerns. The resolution of the Australia Post/mail contractor dispute illustrates the point. Australia Post amended its contracts so that, where necessary, it makes restitution to an aggrieved customer and subsequently seeks recompense from the contractor.

CTC has the potential to enhance accountability by requiring the contracting agency to specify clearly the service to be delivered and to allocate precisely responsibilities between the agency and the contractor for delivery of the service. Every effort should be made to eliminate confusion about the lines of responsibility: they should be kept as clear and as simple as possible.

The Commission notes that it may be more difficult to do this for some services than others. It is an important factor to consider when addressing the advisability of using CTC (see chapter C3).

B1.3.2 Transparency

A key aspect of accountability is the transparency of both decision-making by public administrators and the performance of the service provider (whether internal or external). The importance of public access to information was highlighted in a discussion paper released in May 1995 as part of a joint review of the Freedom of Information legislation by the Australian Law Reform Commission (ALRC) and the Administrative Review Council (ARC):

Access to government information is a pre-requisite to the proper functioning of a democratic society. Without information, people cannot exercise their rights and responsibilities or make informed choices. Information is necessary for government accountability. Limited information can distort the accountability process: governments are questioned about the wrong issues and programs are incorrectly evaluated. Without information people cannot make an informed choice at the ballot box and members of Parliament cannot supervise the Executive. (ALRC 1995, pp. 6-7)

Information on what is being purchased and how well it is being delivered enables those principals in the chain of accountability (the agency, the Minister and Parliament/Council up to the community) to assess the performance of their respective agents.

Contracting may affect the capacity to assess how well different agents have fulfilled the responsibilities they have been delegated. To assist in making transparent the performance of both the service provider and the agency, it is necessary to assess the type and amount of information available on:

- the performance of the service provider, and
- the decisions of the agency relating to the contractual relationship.

The performance of the service provider

It appears that CTC can generally have a positive impact on accountability by ensuring greater transparency of the performance of both contractors and agencies. The NSW Premier's Department was of the view that CTC enhances the capacity of public sector managers to assess the performance of service providers:

Contracting can facilitate control by imposing the discipline of specification development and monitoring against explicit standards. This is often a failure of in-house provision where a manager responsible for assessing performance is also the service provider. (Sub. 199, p. 9)

In similar terms, Sturgess commented:

If competition can be properly harnessed through regular rebids and through benchmarking performance, contracting should produce much greater accountability than the bureaucratic provision of services. (1994, p. 28)

Accountability will be enhanced where the information is available to hold public sector managers (and the service providers) responsible for performance. It has been suggested that, when service delivery is made contestable, the pressure applied by concerned stakeholders and competitors on the contract manager and the contractor to justify their performance increases. For example, the Tasmanian Government observed a favourable impact on accountability in this way:

The experience of agencies has been one of increased accountability where contracting out has been adopted. This increased accountability is a result of the Government needing to be more precise in how it specifies the products or services being provided to meet the outcomes sought ... The discipline of the market place has provided a stronger imperative than where there are internal controls on meeting community expectations. The process tends to be more open, and consumers are more interested in the level and quality of services provided when they can see tax-payer funds going to private sector providers. (Sub. 108, p. 3)

It is understandable that in many instances information levels have improved following CTC. The process of writing down and giving priorities to all aspects of a service and establishing the performance measures will often not have been done or will have been done less thoroughly than is required for a written contract.

As mentioned earlier, however, when the service provider must exercise judgement on the composition or amount of service to be provided to individual clients, identifying success or failure becomes more difficult. Providing a contractor with discretion to determine the best way to deliver a service is the source of many of the benefits associated with contracting (see chapters B3 and C6). However, discretion potentially increases the gap between the information available to principals on performance and the actual activities of the service provider. As a result, the monitoring task to ensure that agents perform efficiently becomes greater.

A 1992 report by the Commonwealth's Task Force on Management Improvement, *The Australian Public Service Reformed*, considered the level of discretion provided to the contractor to be an important determinant of the type of service to be contracted:

Services involving substantial accountability, privacy or control issues or discretion in decision-making by government may best be retained in-house. (p. 21)

The Privacy Commission considered the greater the discretionary judgement required of contractors on behalf of the agency, the greater the potential risk associated with the misuse of confidential information (see also B1.4 below):

There is less risk attaching to contracting out where the services to be performed do not involve the exercise of discretion, that is, the more mechanical the services performed by the contractor, the less chance there is of privacy being placed under threat. (Sub. 124, p. 4)

It may well be difficult for the purchasing agency to identify failure by the contractor when considerable discretion is involved in the provision of a service to individual clients. Both the risk of misuse of such discretion and the potential associated costs need to be taken into account when assessing the scope for contracting out (see chapter C3). This decision should be taken in the context of the redress available to purchasers and clients if discretion is used inappropriately. However, as noted by MAB-MIAC:

In applying the conclusions from this report, agencies will need to take care to avoid the tendency to classify almost every activity as not warranting consideration for competitive tendering because of public interest, accountability and control issues. This would forgo the benefits that have been shown to flow from competitive tendering. (1992, p. 33)

In a number of jurisdictions FoI legislation provides individuals access to the information government holds about them, enabling them to see and challenge the discretionary judgements government and its agents have made about them. The *Freedom of Information Act* 1982 (Commonwealth) provides citizens with a general right of access to documents held by the government, subject to several specified exemptions. FoI legislation also exists in NSW, Victoria, Queensland and Tasmania. However, such legislation does not apply to the private sector.

The Commonwealth Attorney-General's Department commented:

FoI rights belonging to consumers and citizens can only, in connection with contracting out, be safeguarded by legislative extension of the FoI Act to private service providers. The issue of whether or not this is done, is a policy one for the Government. (Sub. 175, p. 7)

The joint review currently being undertaken by the ALRC and the ARC is considering (amongst other issues) whether the Commonwealth FoI and Privacy legislation should be extended to the private sector. This issue extends beyond CTC. However, the Commission notes that the discussion paper (mentioned above) proposed not to extend the FOI Act to the private sector. Instead it argued that, where there is a need for greater disclosure, industry-specific legislation should be amended or introduced. The report is due in early 1996.

CTC has the potential to enhance accountability by requiring the contracting agency to specify clearly, not only the service to be delivered, but also the criteria on which the contractor's performance is to be measured and monitored. The Commission notes that it may be more difficult to do this for some services than others, particularly where the service provider must exercise discretion on the amount and mix of services to be provided to clients.

Information on decisions made by the contracting agency

Decisions made by the contracting agency which impact on the service delivered include the specification of the service; the choice of contractor; and the criteria to measure the performance of the contractor.

During the inquiry there was criticism that various aspects of a contractual relationship are not open to public scrutiny. In particular, concerns were raised about the difficulty in obtaining information on tender specifications (Brotherhood of St Laurence, Sub. 233, p. 7, People's Justice Alliance, Sub. 154, p. 6); the criteria for tender evaluation (ACTU, Sub. 75, p.13); and quantitative and qualitative measures of performance (People's Justice Alliance, Sub. 154, p. 6). The Public Service Association of South Australia commented:

The practice to date, in this State, is to maintain a regime of stringent security about this information. Nothing has been transparent about the development of specifications, nor the criteria for the measurement of contract performance prior to the announcement or signing of contracts. (Sub. 271, p. 1)

In certain circumstances the obligation of government to be open and accountable may legitimately give way to conflicting considerations of “commercial sensitivity”, for example, where information contains valuable intellectual property (see chapter C6). In this context, the Australian Information Industry Association, expressed:

... the concern of its members in relation to the protection of intellectual property in tender responses - both in terms of commercial sensitivity with respect to other tenderers and also in terms of the use by the government organisation of the ideas and approach contained in the tender. (Sub. 287, p. 2)

A number of participants, however, expressed concern that the balance was tilted in favour of non-disclosure of information. The Australian Association of Social Workers stated:

... the general application of the rules of commercial secrecy - which is a natural corollary of market testing and contracting out - will remove much of the crucial data on the awarding of contracts from the public domain and public scrutiny. (Sub. 23, p. 3)

This concern was shared by the ACTU and the People’s Justice Alliance which both claimed that it was difficult to gain access to contracts for management of private prisons. The ACTU raised its concern in relation to the Borallon Correctional Centre (Qld), while the People’s Justice Alliance claimed:

Contracts between the Victorian State Government and CCA (Corrections Corporation of Australia) are not available to the public and not open to public scrutiny on the basis of “commercial confidentiality”.... Many FoI (Freedom of Information) applications relating to private prisons and prison contracts have been denied because of “commercial confidentiality”. (Sub. 154, pp. 6-7)

The practice of disclosure

The practice of disclosure of information appears to differ significantly between levels of government and across jurisdictions.

With respect to the Borallon contract, it is now publicly available (except for details on price). The then acting Director-General of the Queensland Corrective Services Commission, Mr Macionis, explained the evolution of its view on the public release of contracts:

Under the original contracts that we had entered into the contracts were essentially treated as a commercial-in-confidence document. However ... the confidentiality provisions now only relate to a very small number of commercial aspects, and certainly

in relation to those performance specifications, we would now treat those as a public document, so they are available. (Transcript, pp. 470-471)

As far as the Commission is aware, the contracts for the management of private prisons in Victoria are not publicly available. Moreover, the Commission has not been able to establish the Victorian government policy on information disclosure.

The South Australian Government emphasised the need to balance transparency with commercial realities, particularly in relation to contracts involving economic development issues with implications for the future corporate direction of tenderers. The Government also raised the issue of timing and postulated that a distinction should be made between the amount of information that a government should make public during the contracting process and information that should be made available once the process has been completed and contracts signed. It suggested, “there should be fewer restrictions on publicly releasing information after the contracts have been signed”. (Sub. 272, p. 3)

The New South Wales Premier’s Department explained that information relating to the specifications of the service, the criteria for tender evaluation, and the criteria for the measurement of performance was included in the invitations to tender made available to tendering parties. It argued that information:

... could be made available to other parties, perhaps on a user charges basis in the case of substantial specifications in the same way as tenderers are often charged for documents. To the extent allowed by Freedom of Information legislation and relevant policy, agencies must retain the role of determining the information which they consider can be released in any one case. (Sub. 294, p. 1)

At the local government level, the Victorian Local Government (Competitive Tendering) Regulations 1994 require that each council maintain a competitive tendering register and make it available for inspection on request by any person. For each competitive tendering arrangement a council must enter into the register, amongst other information, the tender evaluation criteria and any ranking accorded to that criteria; reasons for entering into the competitive arrangement if the contract was not awarded to the lowest tender; and the estimated value of the competitive arrangement for the financial year in which the competitive arrangement is entered into.

Despite the wariness of a number of contracting agencies, several participants representing tenderers expressed support for the disclosure of information on contracts. Mr Huett, for the Civil Contractors Federation, stated:

... the issue of accountability and complete transparency is to us one of the most fundamental principles of contracting out and we could not stress highly enough how important transparency is. (Transcript, p. 1939)

He also argued that disclosure should extend to revealing the prices of respective bids, a view shared by Serco Australia. (Transcript, p. 1108)

For individuals to be able to hold elected representatives and their agents (the contracting agencies) accountable, information is required on how well they have performed in relation to their delegated responsibilities. For a contracting agency to be held accountable therefore, information is required on the type of service it has decided should be delivered, the choice of the service provider and how well the chosen service provider has performed.

In this context the Commission notes that in 1993 the NSW Public Accounts Committee (PAC) *Report into the Management of Infrastructure Projects* argued for the release, to the public and the Parliament, of a wide range of information, including the price payable by the public, the basis for changes in the price payable by the public, details on significant guarantees or undertakings, details of the transfer of assets and the results of cost-benefit analyses. The type of information it did not consider suitable for disclosure included the private sector's internal cost structure or profit margins, matters having an intellectual property characteristic, and any other matters where disclosure would pose a commercial disadvantage to the contracting firm.

Recommendation B1.1

Recognising the balance between commercial confidentiality and accountability, governments should make public as much information as possible to enable interested people to assess contracting decisions made by agencies. Of particular importance is information on the specifications of the service, the criteria for tender evaluation, the criteria for the measurement of performance and how well the service provider has performed against those criteria.

B1.3.3 The capacity for redress

Another important aspect of accountability is the ability of individuals to seek redress for any perceived infringement of their rights. An important issue is whether their capacity to seek redress is in any way changed where services are contracted and how any potential problems can be addressed.

That will depend on the relative effectiveness of the various mechanisms available for redress and how access to them is affected by contracting. While some of these mechanisms do or can apply universally (eg common law and client complaint mechanisms), others relate primarily to public sector agencies (eg administrative law) or to private contractors (eg contract penalties or termination).

For public sector provision, a legislative framework has evolved to enhance the capacity of the public to seek redress. Providing consumers with access to quick and affordable remedies when they experience problems in their dealings with a government service provider is an objective of Commonwealth, state and territory governments. Administrative appeals tribunals, FoI legislation, and investigative agencies such as the Ombudsman, and the Privacy Commissioner, all attempt to improve the opportunity for redress. The *Commonwealth Ombudsman Act 1976* provides a role for an independent person (the Ombudsman) to investigate complaints from aggrieved citizens about the administrative action of Commonwealth government departments and prescribed authorities. There is also an Ombudsman in each Australian State and the Northern Territory, although in two jurisdictions (Queensland and Western Australia) the officer is the Parliamentary Commissioner for Administrative Investigation.

As to the legal status of these mechanisms where services are contracted, the Commonwealth Attorney-General's Department stated:

While some aspects of the *Privacy Act* or *FoI Act* may still affect, or at least be made by contract to reach, private sector service providers, the substance of these Acts will not do so as they do not apply generally to the private sector. There will be little or no application of the Commonwealth's accountability provisions as contained in the *Ombudsman Act*, the *Administrative Appeals Tribunal Act* and the *Administrative Decisions (Judicial Review) Act* to the private sector. (Sub. 175, p. 5)

A number of participants expressed concerns that the legislative framework that currently exists at the Commonwealth level and in most states does not extend to those services provided by the private sector under contract to government. Underlying this concern was the principle that the legal rights of individuals to seek redress in relation to government-funded services should not be diminished by contracting out.

Particular concern was expressed that the jurisdiction of the Ombudsman does not extend to those services provided by the private sector. The Commonwealth Ombudsman provided a number of case studies illustrating what she saw as unacceptable difficulties in obtaining redress faced by aggrieved persons in situations involving contracting by public sector agencies. In addition to the

damaged letter box (see above), cases included the recovery of medical costs resulting from an accident on an aerobridge and complaints by contractors of unfair contract termination (Sub. 113).

The Commonwealth Ombudsman and several other participants suggested the desirability of extending the jurisdiction of this and other elements of administrative law² to cover the activities of private contractors. Indeed, the Commonwealth Government has taken this approach in one case by extending the administrative law package to private case managers under the *Employment Services Act 1994*.

However, other participants urged caution in adopting such an approach. For example, both the Department of Veterans' Affairs (Sub. 110) and Australian Hearing Services (Sub. 218) argued that intervention by the Ombudsman on behalf of a contractor has undermined their ability to impose sanctions (termination) on contractors who, in their view, were performing unsatisfactorily. Without debating the merits of these particular cases, there is clearly a potential for accountability to become blurred.

Furthermore, the administrative law package may not be as valuable, as a mechanism for redress, where there is competition and choice between service providers. The Administrative Review Council recognised this with regard to Government Business Enterprises (GBEs) and recently recommended against the extension of the administrative law package to their commercial activities. It argued that, where a GBE faces "real competition", its "commercial activities would be as susceptible to private laws as its competitors" and "consumers of goods and services provided by GBEs would be able to direct their custom elsewhere" or "rely upon private law remedies" (ARC 1995, p. 38).

Where private sector contractors face these pressures contracting may improve the opportunity for disaffected people to seek redress. The existence of competitive pressure may help ensure that contractors respond quickly to the concerns of the client. As Swiss (1983) suggested, if there are a number of providers between whom purchasers and (where different) clients can choose either directly or indirectly — by making customer satisfaction part of performance indicators — the capacity to impose effective sanctions will increase. A recent example of this is the arrangement developed by the Employment Services Regulatory Authority (ESRA) whereby individual clients

² The 'administrative law package' comprises several Commonwealth Acts including: the *Administrative Appeals Tribunals Act 1975*; the *Ombudsman Act 1976*; the *Administrative Decisions (Judicial Review) Act 1977*; the *Freedom of Information Act 1982*; the *Archives Act 1983*; and the *Privacy Act 1988*.

can choose between unemployment case managers. The link between accountability and consumer choice was emphasised by DAS:

If I could take that one stage further, the introduction of user choice and in a sense testing of in-house services against alternatives, is the introduction of some form of user choice. It has dramatic effects on the accountability of the service provider to the client. Certainly this has been the case, we believe, in respect of our own services in DAS. As soon as you give somebody choice, you markedly sharpen the accountability of the service provider. (Transcript, p. 1358)

The capacity for redress can be enhanced if clients play a part in enforcing sanctions for inefficient performance. In this context, the South Australian Council of Social Service observed:

Accountability can be enhanced by ensuring that stakeholders are involved in appropriate ways, for example through consumer advocacy groups and peak bodies. Efficient and effective mechanisms can be implemented to improve the quality of contracting mechanisms whilst protecting against collusion or stakeholder self-interest. Guidelines for the operation of such mechanisms are not difficult to develop. (Sub. 58, pp. 2-3)

Even for those complex services that involve the exercise of some discretion by the provider, if there is a sufficient role for clients, accountability can be improved. A good example of this is the Department of Veterans' Affairs Repatriation Private Patient Scheme. Under this scheme veterans have a choice of hospital. They may choose to attend Hollywood Hospital (which has been contracted to Ramsay Health Care Group), a public hospital as a private patient or a non-contracted hospital under certain circumstances. Thus the onus is on Ramsay to perform to customer expectations.

Furthermore, many of the case studies appeared to reflect poor implementation of contracting — for example, poor specification of responsibilities. To some extent at least, the apparent problems to date may be transitional and may fade as public sector agencies gain more experience with contracting. In the case of Australia Post, for example, the Commonwealth Ombudsman noted (Sub. 113, p. 10) that, while it was the subject of a number of complaints, Australia Post appeared to be “at the forefront of contracting out its services” and “has recently shown a willingness to address not just the individual complaint but the core issues so as to avoid a re-occurrence of dissatisfaction”. Nevertheless, the experiences point to the need to adequately incorporate client and public redress issues in individual contracts and in government policy approaches to contracting.

CTC can enhance the capacity to achieve redress where information is available on performance standards and on the results of monitoring. That is also the case where there are a number of providers between whom

purchasers and (where different) clients may choose, either directly between service providers or indirectly by making customer satisfaction part of performance standards.

The Commission considers that a change from direct to contracted provision ought not undermine the ability of individuals or organisations to seek redress for decisions or actions for which governments are accountable. However, the idea of extending administrative law to contractors needs careful consideration by governments and their agencies. In doing so they should consider all the potential costs and benefits taking into account the full range of mechanisms for redress which affect accountability where government services are contracted, particularly the degree of competition and the extent of client or user choice.

B1.4 Privacy of personal information

Depending on the service, a contractor may have a wide set of obligations to fulfil in relation to the client. The duty of care towards clients and the public in general with respect to the protection of privacy is particularly important for services involving a candid relationship between the provider and individual clients.

A question that needs to be considered is whether privacy can be protected as effectively when services are provided by a contractor as when provided internally.

A number of participants expressed concern that contracting increases the risk of misuse of personal information. The Commonwealth Privacy Commissioner suggested that providing contractors with access to personal information may have a number of undesirable consequences, including:

- individuals may be directly disadvantaged by having their information improperly used, stored or disclosed;
- people who have suffered such disadvantage may not have access to means of redress as effective as those available if the information had been handled directly by a Commonwealth agency; and
- individuals may be more reluctant to provide information or to provide accurate information if they know or suspect that it will be accessible to profit making firms as well as the agency with which they are primarily dealing. (Sub. 124, p. 3)

The potential for misuse of confidential information appears to be one of the major factors that the Australian Tax Office (ATO) takes into consideration when determining what services should be open to CTC:

The ATO has had limited experience with contracting out the provision of goods and services that support its operations. This has been due mainly to the nature of our core business activities and the need to maintain privacy and security of sensitive information entrusted to us. (Sub. 87, p. 2)

However, the Tasmanian Government made the point that:

Issues such as ethics, privacy of information and so on, need to be considered in contracting out, but we would question whether there is any inherent difference in standards for professional providers. For example, medical ethics and commercial-in-confidence principles cross government and private sector boundaries. (Sub. 108, p. 9)

Indeed, it was argued that the private sector may be more responsive to considerations of privacy and consumer rights. For example, Best Practice suggested:

... market-forces — including customer and potential customer/community backlash — work to favour the private sector being more responsive to environmental, waste, privacy and other pressures than the public sector. (Sub. 26, p. 13)

Privacy is one of the risk factors that agencies must take into account when considering whether to use CTC (see chapter C3).

B1.4.1 Privacy legislation

At the Commonwealth level, the *Privacy Act* 1988 places legal obligations on Commonwealth agencies to protect the personal information they collect. Currently, no State or Territory government has comparable legislation.

The *Employment Services Act* 1994 extends the provisions of the Commonwealth *Privacy Act* to private sector ‘case managers’ of the long-term unemployed. (see box B1.2).

Box B1.2: Employment Services Act 1994

The Act safeguards consumer rights by enabling affected consumers to request the Employment Services Regulatory Authority (ESRA) to review its decisions. The Act also extends the jurisdiction of the Social Security Appeals Tribunal and the Administrative Appeals Tribunal to review certain decisions made by ESRA. *The Employment Services (Consequential Amendments) Act 1994* extends the jurisdiction of the Ombudsman to include case managers and ESRA. This Act also grants members of the public rights of access to certain documents held by case managers under an amendment to the *Freedom of Information Act 1982* and requires contracted case managers to comply with provisions of the *Privacy Act 1988*.

Source: ESRA, Sub. 139

In preference to extending privacy protection on a case-by-case basis, the Privacy Commissioner argued for the national extension of privacy legislation:

... it would be better to eliminate the need for relatively clumsy measures such as the model clauses by extending a general set of privacy protection to all sectors on a national basis. The ideas would be similar to those embodied in the Information Privacy Principles in the *Privacy Act*. (Sub. 124, p. 7)

The Federal Government's recent 'Innovation Statement' stated:

The Government has decided to develop an effective, comprehensive scheme to protect individual privacy which does not impose unnecessary burdens on business and the community. (Keating, P.J 1995, p.12)

According to the Commonwealth Attorney-General's Department, "the detail of the regime is not yet decided and will be worked out through extensive consultations with industry, consumers and the States and Territories" (Sub. 291, p. 1).

B1.4.2 Privacy clauses in contracts

In determining whether a Commonwealth agency using contractors has met its obligation under the *Privacy Act*, the Privacy Commissioner "would take into account whether it had included appropriate privacy clauses in contracts" (Sub. 270, p. 1). In 1994, the Privacy Commissioner issued *Outsourcing and Privacy*, a paper to assist Commonwealth agencies deal with privacy concerns when contracting. The paper contains model privacy clauses for inclusion in contracts for IT and other services.

While not supported by legislation, a number of state government agencies have adopted similar clauses in contracts. For example, the South Australian Government commented:

To address confidentiality, specific requirements and controls are to be incorporated into the contract and service level agreements. These will ensure that, while IT services are provided externally, the data processed remains the property of the South Australian Government. The service provider will be expected to adhere to data privacy principles, and penalties are being determined for breaches of confidentiality. (Sub. 123, p. 8)

And the Tasmanian Government's position is that "privacy concerns are adequately handled through clauses built in to standard contracts by the Crown Solicitor" (Sub. 108, p. 13).

In relation to Commonwealth contracts, the Privacy Commissioner indicated that few complaints had been received about contracts containing model clauses and that some agencies have:

... indicated that where the clauses have been incorporated in contracts they have functioned effectively and in some cases have been welcomed by the officers managing the contracts as making explicit contractors' responsibilities in regard to privacy. (Sub. 124, p. 7)

When circumstances indicate that particular privacy protection is needed, the inclusion of privacy clauses in contracts seems to be an effective approach.

B1.5 Conclusion

The Commission agrees with numerous participants that, while responsibility to do certain things can be transferred, accountability for the results cannot. Whatever the method of service delivery, a government agency must remain accountable for the efficient performance of the functions delegated to it by government.

CTC inevitably involves redefining responsibilities and relationships between key stakeholders, and introduces a new player — the contracted service provider — into the chain of accountability. Some participants argued that the introduction of this 'new player' can blur accountability for service delivery.

Others considered, as does the Commission, that CTC has the potential to enhance accountability in a number of ways.

First, CTC can enhance accountability by requiring the contracting agency to specify clearly the service to be delivered and to allocate precisely responsibilities between the agency and the contractor for delivery of the

service. This makes it easier to identify if there has been a failure by the contractor or by the agency. Every effort should be made to eliminate confusion about the lines of responsibility: they should be kept as clear and as simple as possible.

Second, CTC can enhance accountability by requiring the contracting agency to specify the criteria on which the contractor's performance is to be measured and monitored. While, in certain circumstances, the obligation of the government to be open and accountable may legitimately give way to conflicting considerations of 'commercial sensitivity' (for example where information contains valuable intellectual property), there should be a preference for disclosure.

Third, CTC can be introduced in a way which enhances the capacity to achieve redress where there are a number of providers between whom purchasers and clients (where different) may choose. A change from direct to contracted provision ought not undermine the ability of individuals or organisations to seek redress for decisions or actions for which governments are accountable.

B2 SERVICE QUALITY

B2.1 Introduction

Key questions for this inquiry are: does contracting affect the quality of a service? If so, how? And, why?

The Commission received evidence that competitive tendering and contracting (CTC) provides an opportunity to improve the quality of service delivery, because there is:

- a better understanding of quality requirements through formal specification;
- greater flexibility in choosing the service providers, which means funders can use providers that specialise in the particular service; and
- a greater focus on service quality and standards by contractors because of the threat of losing a contract.

On the other hand, concern has been expressed that cost savings resulting from CTC are likely to be at the expense of quality, because:

- the organisational separation of the funder and service provider reduces the funder's ability to control the level of quality;
- even where the agency establishes clear quality standards, these might not be met by the contractor because of problems in conveying expected standards to the contractor, poorly drafted contracts which provide ambiguous performance standards, inability to define how quality will be measured, and opportunism by contractors (Rimmer 1993);
- given the difficulties associated with defining, evaluating and monitoring the quality of a service, managers tend to place an unwarranted focus on reducing costs and will select contractors on the basis of the tender price rather than their ability to deliver a quality service (Domberger and Hall 1991); and
- contractors face strong incentives to provide no more than the minimum service specified in the contract.

Given the divergence in views, it is the purpose of this chapter to:

- examine the available evidence on the impact of contracting on the quality of services; and

- consider those factors that may influence whether quality is affected adversely or positively by CTC.

B2.2 The concept of quality

In considering the effect of CTC on quality it is important to understand what is meant by 'quality'. To some participants, quality was synonymous with the best available product or service, while others used phrases such as 'fitness for purpose', 'customer satisfaction', 'conformance to requirements' and 'value for money'. While no single definition captures the meaning of quality, both the literature and the views of inquiry participants reveal a number of common elements.

Walsh (1991b) suggested that the two key aspects of quality are whether the product or service conforms to specifications and whether it is 'fit for the purpose' for which it was intended. The Commonwealth Department of Administrative Services (DAS) recognised both of these aspects:

A quality product or service is the one best suited to the intended purpose, rather than the best money can buy. Essentially, 'quality' means fitness for purpose, or conformance to requirements. (Sub. 140, p. 17)

Judging the quality of the services delivered on both of these aspects is not easy however. For many services it is difficult to assess their quality because they are intangible compared with material products and they consequently cannot be easily stored, sampled for testing or measured (Walsh 1991b).

There may be a further complication when an agency is purchasing services to be delivered to the community (eg parks and home help). For these services it may be more difficult to judge whether the particular quality objectives are being met, because:

- for public services paid for out of taxation revenue, consumers are unable to express their views and preferences directly by using their market power (Hall and Rimmer 1994); and
- the agency funding the service and determining the level of quality may have incomplete knowledge of whether the user of the service considers the service fulfils its intended purpose.

As a result of these problems, standards of quality for public services are often difficult to establish and maintain. It is important to recognise, however, that government agencies face these problems whether they deliver the services themselves or contract out the delivery.

B2.3 The evidence

Attempting to assess the impact of contracting on quality is not easy for several reasons, including:

- the frequent absence of performance evaluation mechanisms prior to introducing CTC makes before and after quality comparisons difficult;
- where quality changes, it is often unclear whether the contractor was not adhering to specifications (an *unplanned* change in quality) or whether a policy decision had been made to use CTC as a mechanism to change quality (a *planned* change in quality);
- it is at times difficult to isolate the effects on service quality attributable to CTC from concurrent reforms, such as local government amalgamations; and
- the quality of service may not have changed as a result of contracting, but the basis on which quality is judged may have changed. What was an acceptable level of service in the past, may no longer be so.

B2.3.1 Empirical studies

Despite these hindrances, a number of empirical studies provide some evidence about the impact of CTC on quality. Table B2.1 lists the Australian studies that have attempted to examine whether contracting has led to a measurable change in quality. Of the Australian evidence, the Evatt Research Centre study concluded that “there is tentative evidence to suggest that lower costs may be achieved in many cases at the expense of service quality” (1990, p. 62), and the Rimmer study (1993) observed that most councils indicated quality had declined with contracting. All other studies have found either no evidence of quality deterioration or an improvement.

Given the inherent difficulties in measuring quality and the small sample size of most of these studies, care needs to be taken when interpreting the results. In relation to the studies undertaken in NSW and WA, the Public Sector Research Centre (PSRC, Sub. 214) argued that there are further methodological deficiencies, including that:

- the research does not make a distinction between reductions in quality deriving from inappropriate specifications, and quality problems arising from the failure to meet the standard specified; and

- there is a reliance on subjective measures of quality (such as the opinions of those who filled in questionnaires) rather than attempting to look at objective measures, such as contract failures, penalties, and client surveys.

This last concern applies also to the Evatt and Rimmer studies in which survey respondents considered quality to have declined following contracting.

Table B2.1: Australian studies of impact of CTC on service quality

<i>Study</i>	<i>Year</i>	<i>Service(s) & data</i>	<i>Quality Change</i>
Rimmer	1988a	Cleaning services; data from 13 Melbourne municipalities	No change or improved
Evatt Research Centre	1990	Various services; data from 460 Aust. municipalities	Often reduced
Domberger, Farago, Hall and Li	1993	Various services; data from NSW budget sector	No change or improved ^a
Rimmer	1993	Various services; responses from 31 NSW & Vic councils	Varied outcomes, more often reduced ^b
Farago, Domberger, Hall and Li	1994	Various services; data from NSW public sector	No change or improved ^a
Farago, Hall and Domberger	1994	Various services; data from WA public sector	No change ^a
Domberger, Hall and Li	1995	Cleaning services; data from Sydney region	35% improvement ^c Not statistically different from zero ^d

^a In these three studies respondents were asked to rate the effectiveness of the contracting of each service. Effectiveness was defined as 'to ensure service delivery'. The findings are based on the high proportion of responses stating that the effectiveness of the outcome had either been successful or very successful.

^b Councils were asked to list the advantages and disadvantages of contracting. Seven responses indicated that quality had improved with contracting, while 24 responses indicated that it had declined.

^c Estimate for the quality of cleaning in special schools.

^d Estimate for the quality of cleaning in offices, hospitals and other schools.

Table B2.2 lists the available overseas studies that have examined the effect of contracting on quality. While the findings vary, there is some evidence that contracting may have had a deleterious effect on quality in the services considered. Appendix E provides a more detailed explanation of these studies.

Table B2.2: Overseas studies of impact of CTC on service quality

<i>Study</i>	<i>Year</i>	<i>Service(s) & data</i>	<i>Quality Change</i>
Savas (US)	1977a	Waste collection; data from the City of Minneapolis	No change
Stevens (US)	1984	Various services; data from Los Angeles district	No statistically significant difference
Hartley and Huby (UK)	1986	Various services; data from local govt. & health authorities	Some evidence of quality decline
Ascher (UK)	1987	Various services; data from Wandsworth Council	Varied outcomes, more often reduced
Pack (US)	1989	Various services; data from 15 cities & counties	Approximately 25% had quality problems
McMaster (UK)	1995	Various services; data from local govt. & health authorities	57% no change, 20% quality improved, 23% quality problems

B2.3.2 Survey of Commonwealth budget-funded agencies

In the Commission survey of Commonwealth budget-funded agencies conducted for this inquiry, respondents rated the quality of service, compared with their expectations, as much better or better for 50 per cent of contracts, fair for 47 per cent and poor for 3 per cent of contracts. While this is a subjective measure, it was based on 994 contracts and there was an attempt to exclude services where a reduction in the level of service was planned by the purchasing agency.

Information collected on the more objective measures of contract failure revealed 34 recorded instances of where contracts were terminated or not renewed, of which about half were for unsatisfactory service. Unplanned deteriorations in quality appeared to affect only a very small proportion of the contracts.

B2.3.3 Evidence presented to the inquiry

A range of anecdotal evidence was presented to this inquiry about the impact on service quality.

Various participants provided examples where they considered that CTC had led to improved service. The Department of Social Security (DSS) reported:

Overall, the experiences with contracting out undertaken by DSS indicate that the quality of outcomes has been good. DSS has benefited from the utilisation of up to date specialist skills offered by the private sector and is confident that value for money has

been achieved through the contracting out of activities which would otherwise have been conducted in-house. (Sub. 138, p. 7)

This view was supported by Serco Australia:

Almost without exception our customers report that the process of contracting out results in improved service levels. This occurs not only where specifications have provided for improvements but also where customers have aimed only to achieve the status quo. (Sub. 144, p. 2)

Box B2.1 summarises a number of examples of service quality improvements that have been provided by participants during the course of the inquiry.

Box B2.1: Examples of reported quality improvements	
<i>Agency</i>	<i>Reported result</i>
RGH Greenslopes (Brisbane) and RGH Hollywood (Perth)	A greater focus on satisfying client demands and facilitation of the provision of localised treatment for veterans. (Repatriation Commission/Department of Veterans' Affairs, Sub. 110)
Department of Social Security	Greater flexibility and choice in service providers and an increase in control of outcomes through the Department's ability to access the expertise of quality service providers. (DSS, Sub. 138)
Maternal and child health services (City of Stonnington, Vic)	Following a process of CTC an in-house team was selected to run the city's maternal and child health services. The team won the bid after offering an enhanced service, including extending operating hours, developing new programs and offering enhanced facilities. (Stonnington Council, Sub. 322)
Melbourne Water	An improvement in the time to repair burst water and sewerage mains from the contracting of water and sewerage network maintenance. (Serco Australia, Sub. 144)
National Library	Improved service quality as a result of ability to hire expertise. (National Library of Australia, Sub. 25)
NSW Government QStores	Contracting out of warehouse management has resulted in an improvement in order delivery times from an average of 8 weeks before contracting to less than 2 days in the metropolitan area now. This service level improvement was anticipated. (Serco Australia, Sub. 144)
Sydney Water	Contracting of meter reading has reduced the meter reading cycle from 1 year to 8 weeks. Meter replacement times have improved from 21 to 7 days and emergency call out response times have been more than halved. (Sydney Water, Sub. 150)
Victorian State Supply	Lead times reduced from 1-8 weeks to a reliable next day delivery even in periods of fluctuating demand. (Vic. Government, Sub. 215)
Vic Courier	An ability to offer an equivalent next day service at half the cost of the previous internal service, or an overnight service which previously could not be offered using internal resources. (Vic. Government, Sub. 215)

However, other participants expressed concern that any cost savings resulting from contracting are likely to be at the expense of quality. The ACTU was of this view:

Case studies show that service quality often suffers in the contracting process, since contractors' priority is to reduce costs, and quality issues, including equitable access to services for women and other EEO designated groups, are difficult to specify and monitor. (Sub. 75, p. 6)

The ACTU and a number of other participants provided examples of where they considered quality had declined following CTC. These are summarised in box B2.2.

Box B2.2: Examples of reported declines in quality	
<i>Service</i>	<i>Reported result</i>
Junee Prison (NSW)	Service not consistent with tender. (People's Justice Alliance, Sub. 154)
Commonwealth Attorney-General's Department	The LOIS IT system contract was terminated after the contractor failed to deliver. (ACTU, Sub. 75)
Keilor City Council (Vic)	Kindergarten cleaning service levels were seen to be inconsistent with specifications. (ACTU, Sub. 75)
Melbourne City Council (Vic)	Quality suffered as a result of the contractor not having the requisite equipment for road verge and median strip mowing. (ACTU, Sub. 75)
King George V Hospital (NSW)	Cleaning service contract terminated after failure to meet desired service level. (ACTU, Sub. 75)
NSW school cleaning	Survey of principals revealed dissatisfaction with level of service. (NSW Teachers' Federation, Sub. 131)
Metropolitan Ambulance Service (Vic)	Lower service standards for non-emergency patient delivery. (ACTU, Sub. 75)
Borallon Prison (Qld)	Poor employment/staffing practices and a lack of quality work and training for inmates. (People's Justice Alliance, Sub. 154)
Waggamba Shire Council (Qld)	Road construction job of poor quality in comparison to road construction undertaken by day labour force. (Waggamba Shire Council, Sub. 262, p. 2)

There is often disagreement regarding the impact of contracting on quality for different services. For instance, while the ACTU stated that ambulance service quality has deteriorated, the Metropolitan Ambulance Service (Victoria)

commented in reply that contracting out different ambulance services has had the effect of:

... providing the service on a more cost-efficient basis while maintaining and enhancing the level of quality of service provided. (Sub. 224, p. 1)

Similarly, the performance of cleaning contractors in New South Wales schools has been the subject of contention. A survey of school principals by the New South Wales Teachers' Federation (NSWTF) identified dissatisfaction with the cleanliness of schools cleaned by contract cleaners. While the results of this survey are not consistent with independent assessments undertaken in 1992¹ and in 1994-95² (Sub. 221), the NSW Government in August 1995 accepted the recommendations of a further review which found that the contract specifications were inadequate. New specifications are to be negotiated.

Concerns regarding the quality of school cleaning were also expressed by the State School Teachers' Union of Western Australia. It stated:

School cleaning may be cheaper now but the effect on schools in the last few months is already noticeable. Many schools are now just plain grubby - desks are not washed, library shelves are not dusted, floors not cleaned as regularly as before. (Sub. 85, p. 2)

However, the union was unable to suggest whether the alleged quality problem was a result of poor specification, monitoring or a deliberate change in the standard (Transcript, p. 415). Furthermore, both the Education Department of Western Australia (Sub. 284) and the Master Cleaners Guild of Western Australia (Sub. 241) pointed out that only a very small number of schools across the state have been cleaned so far by private contractors and none of these have been subjected to the process of CTC.

The People's Justice Alliance was critical of the quality of prisoner care following the contracting of certain correctional services. In particular it argued that poor employment/staffing practices and a lack of quality training and work for inmates were evident at the privately-operated Borallon Correctional Centre (Qld); and that the services provided at the privately-operated Junee prison (NSW) were not consistent with the tender specifications. However, a recent audit report for Borallon prison did not identify any major problems with service levels. Indeed, far fewer problems were identified by the auditor at

¹ CTC Research Team of the Graduate School of Business, the University of Sydney, commissioned by the NSW Government Cleaning Service (GCS), found that the difference in performance between GCS-cleaned schools and contractor-cleaned schools was not statistically significant.

² A further study, commissioned by the NSW Commercial Services Group (Contract Monitoring Unit) and undertaken by the CTC Research Team, concluded that performance for all schools had improved overall by nine per cent since 1992-93.

Borallon than at the government-operated prison at Lotus Glen (Qld) (Queensland Corrective Services Commission 1994 and 1995).

From the wealth of material that has been examined in the inquiry, the Commission concludes there are examples of where quality has gone up, gone down and remained the same after the introduction of CTC.

B2.4 The key factors influencing the impact of CTC on quality

In the evidence to this inquiry and the available literature a number of reasons have been given why competition and contracting may influence quality. They include the adequacy of the CTC process (ie the success or failure in contract specification, selecting and monitoring a contractor); the impact of the organisational separation between the funder of the service and the provider; and the implications of making the delivery of the service contestable. These are discussed below.

A further factor is the nature of the contractual relationship. A strong agency/contractor relationship can lead to an improvement in the quality of the service. This aspect is discussed in chapter C4.

B2.4.1 The adequacy of the CTC process

Significant steps in the delivery of any public service are:

- specifying an appropriate level of quality after considering the needs of all stakeholders;
- selecting a service provider who is receptive to the needs of the various stakeholders; and
- monitoring the performance of the service provider to ensure that it meets the needs of various stakeholders (including the purchasing agency, the client, and the community more generally).

Where CTC is introduced the contracting agency necessarily has to reconsider each of these aspects. The way the agency handles these steps appears to have a significant bearing on the level of service quality.

Specification of the service

Where services are subject to CTC, the contract becomes the formal mechanism through which the expected level of quality is specified. A well-developed

contract is the primary source of information for the contractor on the level of performance expected. As suggested by the Civil Contractors Federation:

The contractor is accountable to the council for performance in accordance with the specification. A poorly written specification reduces council's control over service delivery. Mistakes in a specification can be extremely difficult and costly to correct! (Sub. 53a, p. 34)

To ensure the level of service meets the expectations of the various stakeholders, it is crucial that the service outcomes expected are clearly specified in the contract. Where this is not done, the result may be unsatisfactory. The Insurance and Superannuation Commission (ISC) observed the link between quality outcomes and contract specification:

The ISC considers tender and contract specification to be of vital importance. After reviewing contracts, both successful and less successful, it was found that the fundamental difference was the degree of project management on our behalf. On most occasions, the better the planning, the better the outcome. (Sub. 99, p. 3)

Service quality can improve as a result of the process of contract specification. Many government agencies that have undertaken CTC consider that the process of specification enhances the quality of services, because it forces them to reconsider the standard of service delivery. For example, the City of Port Phillip commented:

In developing a specification, we will be taking the opportunity to review and improve the standard of service which we provide to our community. The service planning or specification process inherent in competitive tendering focuses the attention of the whole organisation on national and international best practice in the delivery of our services. (Sub. 170, p. 3)

However, as appears to have been the case with the NSW Government Cleaning Service, poor contract specification can create quality problems. The reported decline in the quality of kindergarten cleaning services in Keilor (Victoria) following contracting to the private sector would appear to have been a result of poor specification. As stated by the ACTU:

Specifications, consistent with guidelines on tender specification were written with a focus on outputs rather than inputs. However this has led to the successful contractor concluding that it is only necessary to clean the windows of buildings on the inside rather than both the inside and outside as was the case before the service was competitively tendered. (Sub. 75, p. 66)

Both cases highlight the importance of carefully and explicitly defining the expected level of service quality. Where a service is being provided by a contractor, the expected level of quality (or performance in relation to any element of service effectiveness) needs to be made clear to the contractor. The Tasmanian Government observed:

It cannot be assumed that a contractor will deliver anything that is outside the defined scope, but which may be implied by the contract. Consequently, poor specification will leave the purchaser with an incomplete product or service and an associated higher risk. (Sub. 108, p. 21)

Furthermore, in some instances a reduction in quality may reflect a deliberate policy decision by governments rather than being a result of poor contract specification. This appears to have been the case in the example cited by the ACTU of a decline in quality of the Adult Migrant English Service:

These English services are now contracted out to private providers. The provision of child care services was not included in the tender specification and private providers do not provide child care for those attending the classes. This means that the contracted service is not providing the same level of access to the service previously provided by the public sector. (Sub. 75, p. 26)

Overall, the process of specification provides an opportunity to review the quality of the service. Those unplanned reductions in service quality attributable to poor specification appear to be largely avoidable. Chapter C6 examines some of the approaches to better contract specification.

Selecting a contractor

CTC introduces choice as to who should deliver the service. The ability of the chosen contractor to deliver the service quality promised is a crucial element in achieving a successful outcome. If contract specifications are met or exceeded, it can be assumed that an appropriate contractor was selected. However, in a number of the instances where there was an unplanned reduction in service quality, the appropriateness of the selected contractor appears to have been a contributing factor.

For example, the CTC Research Team examination of the contract between Sutherland Shire Council (NSW) and Linfox Transport indicated Linfox's inexperience in garbage collection services as a significant factor in the failure of the contract:

Both parties give different reasons for the costly failure of the Sutherland Shire garbage collection contract. Linfox readily admits that it under-estimated the special nature of the garbage collection industry. Although the company had vast experience in the transportation of goods, it found the highly specialised garbage collection equipment, the people who operated it and the culture of the Council formidable challenges. It also admits that it regarded the Sutherland contract as simply another transport contract. (Domberger and Hall 1995, p. 53)

While the choice that CTC provides when selecting a service provider increases the scope for picking someone inappropriate, there are ways to reduce this risk. Methods to minimise inappropriate contractor selection, in particular the use of

multi-stage tendering processes and requiring an appropriate level of quality assurance, are discussed in chapters C6 and C7 respectively.

Moreover, the choice in selection provided by CTC appears to have enabled many agencies to improve service quality by drawing on outside expertise. For example, the National Library of Australia commented:

Generally, the Library has recorded improved service quality through contracting out. For example, the contracting of building maintenance to a commercial firm has provided a more cost-effective and responsive service which is relatively easily managed and monitored. A major advantage in this case is the ability to hire expertise and obtain high quality contract staff ... (Sub. 25, pp. 3-4)

For DSS, choice in service provider has a significant bearing on quality:

Contracting out of services has proven to provide greater flexibility and choice in service providers and an increase in control of outcomes through the Department's ability to access the expertise of quality service providers. (Sub. 138, p. 6)

Monitoring contractor performance

Whether services are delivered internally or externally, the development of processes that enable an agency to determine whether the service provider is meeting acceptable performance standards will also have a significant bearing on quality. Without an effective monitoring regime, there is no way of knowing whether the service provider is meeting the expectations of those funding the service or whether the stakeholders are satisfied with the service.

While the need to monitor the quality outcomes of service delivery is not peculiar to contracted services, the South Australian Government argued that performance monitoring has improved as a result of contracting:

Performance monitoring under this contractual arrangement appears to have improved in comparison with existing in-house provision of services as the relationship with the service provider is to be closely managed with a focus on contract administration and an emerging need to specify and give consideration to service levels and requirements. (Sub. 123, p. 7)

According to the Victorian Government, it is the improvements in performance monitoring that can occur as a result of contracting out that produces further improvements in the quality of services:

Contracting out *per se* does not necessarily impact on the quality of services provided. This is borne out by information provided by Departments which indicate that outsourcing has, at worst, a neutral impact on quality of service ... On the other hand, performance contracts which focus on performance measurement can engender strong incentives for service improvement. This is supported by the results achieved by the Department of Treasury and Finance following the outsourcing of State Supply and Vic Courier. (Sub. 215, p. 18)

It would appear that CTC has provided the impetus for innovative approaches to monitoring. This is not an unexpected outcome of CTC given that it makes the need and type of monitoring explicit. Some of the monitoring methods that have been adopted under CTC are considered in detail in chapter C7.

The contracting agency's approach to the CTC process is an important determinant of the impact that CTC has on service quality. Based on the evidence presented to this inquiry, the Commission considers:

- **improvements in quality can occur as a result of better specification of the service, improvements in monitoring and the ability to access external expertise; and**
- **agencies can largely avoid any unplanned reductions in quality that derive from failure in the tendering process (including inadequate specification of the service required and inappropriate contractor selection) and poor contract management (including insufficient performance monitoring).**

In response to the draft report, the Australian Education Union argued that process-related failures are “both endemic and inherent in the process of CTC” (Sub. 286, p.1). The suggestion was that the CTC process is too complex to be applied well in the majority of cases. This argument, however, appears to explain ‘successes’ as either inadequate assessments of outcomes or, implicitly, as flukes.

The Commission does not accept this analysis because:

- there are many examples of successes over long periods in many jurisdictions;
- there are examples of successful contracting out of services in some jurisdictions whereas their contracting in other jurisdictions are cited as quality failures: for example, the successful use of contract cleaners in ACT schools compared with the NSW schools' cleaning experience; or the successful contracting of garbage services in many jurisdictions compared with the Sutherland Shire experience; and
- there are successes in services often cited as complex, with discretionary elements and high cost and risk of failure: for example, hospital services for veterans.

The Commission therefore remains of the view that good application of process (either in selecting the service for CTC or in subjecting the service to CTC) is achievable and that unplanned quality reductions are primarily a result of poor application of process rather than CTC per se.

B2.4.2 Organisational separation of roles of the purchaser and provider

Besides the introduction of competition the other key change under CTC is that it results in a formal separation of the purchaser and the provider of the service. For certain services this separation has always existed. Many community services, for instance, have traditionally been delivered by private organisations funded by government. For other services the introduction of CTC represents a significant organisational reform. Different views were presented to the inquiry on the effect of the separation on service quality.

The interaction between policy development and service delivery

It has been argued that, where quality is more difficult to specify and measure, it is better to have those involved in policy development for the particular service directly involved in service delivery and vice versa. Separation of the purchaser and provider is considered to diminish the contact between the policy makers and the clients of services and therefore reduces the opportunity for the views of clients (or their representatives) to be fed into the policy process.

The Victorian Council of Social Service said:

One of the main criticisms of the purchaser/provider split, the separation of policy development and policy implementation, is that it distances decision makers from 'coal face' service providers and the recipient or client of the service, which can be detrimental to the development of truly responsive services and appropriate forward planning. (Sub. 155, p. 3)

The People's Justice Alliance supported the view that, where service providers do not have a sufficient understanding of the 'policy objectives' of certain services, the stated and implied needs of different stakeholders will not necessarily be met:

Documented evidence of private prison service delivery both interstate and overseas clearly demonstrates inadequate and at times grossly negligent service provision. Service delivery appears to be linked primarily to profit maximising considerations of managing corporations rather than the needs of the client (prisoner). (Sub. 154, p. 11)

Other inquiry participants, however, considered that the separation of the purchaser and provider has a beneficial impact on service quality. For instance, the Tasmanian Government argued:

... the funder/purchaser/provider split enables a stronger focus for the public sector agency on quality and demand satisfaction. Contracting services to community based organisations has the potential effect of increasing service responsiveness. Maximising commercial competition also offers the potential to increase client satisfaction. (Sub. 108, p. 13)

Furthermore, it has been suggested that contractors often have a greater awareness of client needs and more incentive to serve them. The Johnstone Shire Council (Qld) said:

... in the area of Welfare services, it is probable that contractors would have greater awareness of client needs. Respite Care, Child Care, Youth and Aged Care are all areas where governments/agencies should be facilitating service provision by way of contracting out wherever there is a contractor available with the necessary expertise and administrative structures. (Sub. 17, p. 2)

There is evidence that CTC has led to increased client satisfaction. For instance, the Department of Veterans' Affairs argued that CTC:

... has led to a greater focus on satisfying client demands as it facilitates the provision of localised treatment for veterans. In view of the high profile the Department has with its client base, there is little doubt that veterans, as consumers would know where to turn in the event of problems. (Sub. 110, p. 9)

The recent publication *Clarifying the Exchange: A Review of Purchaser/Provider Arrangements* (Department of Finance 1995c) also gave some examples of where the purchaser/provider split has led to improved client responsiveness in Australia, the UK and New Zealand (p. 10) and also how it can reduce "capture" of government decision-making by those with a vested interest in the decisions (pp. 11-12).

The Commission considers that there is no necessary reason why the separation of those providing policy advice from those delivering services should lead to a reduction or an increase in quality. The important issue to be addressed by agencies is that policy advisers make sure that they have arrangements in place to obtain information on quality specifications and performance from a wide range of sources including existing suppliers, alternative suppliers and clients or their representatives.

Services where it is difficult to determine client needs

Specifying the appropriate level of service quality is easier for some services than for others. In some cases clients can measure the level of quality and provide feedback to the service provider (eg refuse collection). Clients can also influence quality outcomes when they can choose between different providers of goods or services.

However, specification and measurement difficulties are likely to increase where services are purchased by the public agency for delivery to individuals and where the provider (a public agency, a not-for-profit organisation or a private contractor) must exercise discretion about how much to provide each user. These difficulties seem most likely to arise:

- where the future needs of individual clients³ cannot be predicted because their needs may change over time — for example, with aged care and disability services; and
- where there is no standard measure of quality because the outcome of a service depends on the way different clients respond to different elements of the service (as with child care and prisoner management) or on the information obtained once the service starts to be provided (eg counselling).

The Tasmanian Government considered that these factors arise particularly in human service areas:

While quality measures can be explicitly incorporated into contracts, specifying and then auditing quality creates many problems. This is particularly the case for contracts that cover human services. In this area it is less likely that all aspects of quality management are defined, due to the difficulty in measuring long term outcomes. (Sub. 108, p. 13)

The Meerilinga Young Childrens' Foundation concurred:

Quality is very complex in the community services industry. It is simply not possible for many of the indicators of quality to be measured let alone incorporated into a contract. Most outcome measures are likely, at best, to be an approximation. How do you measure 'happiness', 'a sense of security', 'an improvement in a relationship', 'a mother's sanity' or 'more appropriate grieving' which are just a few of the outcomes a community service might produce. (Sub. 173, pp. 3-4)

The problems of securing quality outcomes for these type of services has been a constant source of concern for governments regardless of the method of service delivery.

The Commission does not consider that the problems are exacerbated by the organisational separation of the roles of the purchaser and provider. It notes that, for example, many human services have been traditionally funded by governments but provided by other organisations. It also notes that, under such arrangements and where the services are delivered in-house, decisions on the precise service to be delivered are often made by staff on a de facto basis. Setting down such matters in contracts (or service agreements) under CTC provides the purchaser with some control over setting and monitoring standards and this will enhance accountability.

A related matter is the role for CTC in emergency services, such as flood and bushfire response. The views of participants were divided on this matter, but

³ 'Clients' refers here to individuals who are the final users of the good or service that the contractor is producing. It does not include the public agency which purchases, through a contractual arrangement, the good or service.

examples were provided of emergency services being successfully contracted out (see box B2.3).

B2.4.3 The extent and effect of competition

For some services the market may be too small to attract many competing bids and this is likely to reduce the pressure to present cost-effective and innovative proposals. As a consequence, service quality may suffer. The Tasmanian Government was concerned:

Where the Government dominates the market local tenderers can be small and lack experience and technology, and yet the project may be too small to attract serious interest from mainland or international competitors. This limited competition can have the effect of restricting the benefits achievable from contracting out. (Sub. 108, p. 2)

It was suggested that competition is likely to be less for highly specialised services, such as those in the community welfare industry. The South Australian Council of Social Service said:

In many areas of Human Services the potential for the creation of a market or quasi-market of suppliers is small. The costs of doing so are likely to outweigh the benefits. However, it should be noted that where there is an attempt to create a market of suppliers, the result may look more like an oligopoly than a market of competitors. Competitive tendering may simply have the effect of driving out small providers in favour of larger established organisations. (Sub. 58, p. 6)

Box B2.3 Contracting emergency services

A good number of participants identified the ability to respond to *emergencies*, such as floods and bushfires, as examples of the difficulty in predicting future service requirements. Because of this difficulty, it has been argued by a number of local councils that services need to be retained in-house. The New England Local Government (NSW) put this view:

In isolated areas councils need to maintain staff and plant to provide services and works programs at the highest possible level. This has the added benefit of allowing councils to respond to emergency situations. If contractors are employed from outside the area councils are concerned that the contractors may not be able to respond to such emergencies if on another contract elsewhere. (Sub. 211, p. 2)

In contrast, the Civil Contractors Federation argued that contractors could be used as long as expectations were clearly specified:

Councils should consider their access to contractors in the event of emergencies. The specification should clearly indicate the requirements in an emergency situation. If a contractor is to be required in an emergency, council should consider whether this would give the contractor potentially conflicting contractual obligations. (Sub. 53a, p. 37)

However, the Johnstone Shire Council (Qld) was of the opinion that:

... the restrictions of contract terms and conditions will serve to reduce ability to react to emergency situations and other non-routine duties. (Sub. 17, p. 4)

Contracting of emergency services has occurred. For example, the Northern Territory Department of Transport and Works has contracted out all maintenance and emergency work, including the 'after-hours' emergency phone number.

Furthermore, as the Repatriation Commission and the Department of Veterans' Affairs pointed out:

... there are many examples of private provision of services where the costs of failure are potentially high. Not all emergency health care is provided by government, the use of private mediation is a growing substitute for the use of judicial power; maintenance of front-line defence equipment is not done exclusively in-house. A reasonable conclusion is that this is not an intrinsically significant limiting factor. (Sub. 110, p. 4)

After considering the views of its members, the National Emergency Management Committee, Australia's peak consultative emergency management forum, concluded:

... public sector managers must consider the risks to the safety of the Australian public and to property associated with major hazards when assessing what resources should be contracted out. The contracting process must be well managed and contain clauses which, at a minimum, maintain the current level of effectiveness of emergency management and provide safeguards for the Australian community. (Sub. 317, p. 5)

This concern does not appear to have been borne out by the experience of the Employment Service Regulatory Authority (ESRA) in providing case management services to the unemployed:

It has been ESRA's clear strategy to promote market entry by a large number of relatively small organisations. To this end we have pursued competition at a regional level ... We have helped ensure market entry by small to medium enterprises by providing advances on contracts, and paying a portion of the fees up front as well as paying for outcomes. (Sub. 278, p. 2)

Where low levels of competition do prevail, emphasis should be given to creating an environment conducive to increasing potential competition or contestability. This matter is explored in detail in chapter C4.

On the other hand, some inquiry participants were concerned that competition might be excessive at times. They argued that this could have a deleterious effect on the quality of a service, primarily by increasing the likelihood of under-bidding by contractors. Successful tenderers might then reduce the level of quality to maintain profit margins. The NSW Teachers' Federation, for instance, claimed that schools are not as clean as they should be because:

The hourly rate has not changed significantly, so for the private operators to make a profit, they have necessarily had to save on the number of workers and/or the hours actually worked. (Sub. 131, p. 12)

The adverse implications of evaluating tenders based on lowest price were emphasised by Pacific Waste Management:

The historical practice of evaluating tenders based upon the lowest price will inevitably put at risk the quality of the services provided. The risk of contract failure and substandard performance will increase. (Sub. 52, p. 6)

Public sector managers often face pressure to select service providers on the basis of price. The concern with probity when dealing with public funds provides a strong incentive to select the lowest price tender. The Association of Consulting Engineers of Australia commented:

There is a strong culture amongst those that procure services for the public sector that they must tender for all services and accept the lowest bid in the interest of probity. This is an immature approach not shared by the majority of private sector clients where team relationships are developed with their suppliers. In Queensland, for example, public servants are required to write a report justifying their actions if they do not accept the lowest bid. There is also the spectre of investigation by the various parliamentary investigating committees or ICAC [Independent Commission Against Corruption] and its counterparts. As a result the service provided is often not the most appropriate. (Sub. 38, p. 11)

These various points underline the importance of having 'value for money' as a key evaluation criterion, a matter examined in detail in chapter C6.

B2.5 Conclusion

From the studies that have been undertaken both in Australia and overseas, there is little consensus on the impact of contracting on the quality of publicly-funded services.

Examples of both improvements and unplanned reductions in quality following contracting were presented to this inquiry. The improvements in quality reported after CTC appear to arise because of a much clearer focus on what is required in the service, improved performance monitoring and the ability to choose between alternative providers.

Unplanned reductions in quality often appeared to be a result of inadequate contract specification, inappropriate contractor selection and poor contract management, including performance monitoring. These are not an inevitable consequence of CTC. Good application of process is achievable.

It is recognised that the difficulties involved in, and the cost of, specifying and measuring outcomes vary for different types of services. Where the agency has to deliver services to individuals whose present and future needs are difficult to determine, specifying and monitoring quality are particularly difficult. However, that does not necessarily preclude the use of contracting. There are ways to tackle these issues which will help ensure satisfactory service quality, while still allowing contestability — and they are discussed in chapter C7.

B3 THE COSTS OF SERVICE PROVISION

B3.1 Introduction

Much of the debate on the merits of competitive tendering and contracting (CTC) has focussed on its cost-effectiveness and its impact on efficiency.

Key issues in this debate are whether CTC can provide cost savings; whether such savings have been measured properly; whether savings are maintained in the long term; and to what extent savings represent efficiency gains or transfers from one group to another. This chapter examines these issues. This chapter is not intended as a guide to decision-making for public sector managers (which is dealt with in chapter C3), but an overall assessment of the effects of CTC on the costs of service delivery.

B3.2 A basis for assessing the effect on costs

A number of participants criticised published studies of the cost savings available from CTC on the grounds that not all costs are included or accurately measured. For example, the Public Sector Research Centre (PSRC) was particularly critical of the omission of adequate monitoring and management costs from the calculations in many studies, but it also acknowledged that “in many cases, detailed costings of services before competitive tendering are simply not available” (Sub. 214, p. 4). Similarly, the Evatt Research Centre stated “research of the apparent cost savings of contracting out has been overly simplistic” (1990, p. 9).

The Commission has shared these concerns. In its 1994 *Defence Procurement* report (IC 1994b), it noted that there were omissions in the Department of Defence’s estimates of savings under its Commercial Support Program (CSP):

The estimated annual savings do not, however, include any provision for the administrative costs of running the program such as for the CSP policy and management cells throughout Defence and for preparing in-house bids. (p. 72)

With regard to accurately identifying the costs of service delivery through CTC, it is possible that the actual costs may differ from the price agreed to in the contract — for example, when extra services are required or where there are cost overruns met by the contracting agency. In this case, the final cost of the contract is the appropriate cost to consider. Similarly, the final cost is the most

appropriate cost to consider when assessing the costs of internal provision. Unfortunately, this cannot be done until the contract period is completed.

When assessing the costs of contracting, public sector managers should consider not just the contract price but also out-turn costs or savings (the direct costs or savings from producing individual units of the service), the costs of equipment supplied by the agency, monitoring and management costs, tendering and contract costs and transition costs.

In the same vein, as all of the costs of CTC should be considered, so should all of the costs of internal delivery. As the Victorian Government noted:

The costs of managing an in-house service are often not identified. These costs can be at least as significant as the cost of contract management. Conversely, it is important to explicitly provide for the resourcing of contract management and monitoring. (Sub. 215, p. 23)

To assess the cost effects of CTC, it is necessary first to calculate the base against which they should be measured — the costs of the existing internal delivery or, where it is a new service, the likely costs of internal delivery.

The attachment to appendix E examines in some detail the items which may need to be considered by agencies in assessing the costs of both internal provision and CTC. These items are summarised in table B3.1.

Table B3.1: Costs of internal provision and contracting

<i>Internal provision costs</i>	<i>Contracting costs</i>
Labour costs	Contract price
Operating and maintenance costs	Out-turn costs or savings
Capital costs	Government furnished equipment and materials costs
Administrative costs	Management and monitoring costs
Management and monitoring costs	Tendering and contract costs
	Transition costs

While many commentators have noted that it is often difficult to obtain data on all the relevant costs (eg see Wisniewski 1992), in the absence of comprehensive data an approximation of the main areas of costs should be made.

To determine the cost impacts of CTC, all of the costs of CTC at both the time of tender evaluation and contract completion should be compared with all of the costs of internal provision.

B3.3 Cost impacts

B3.3.1 Evidence of cost impacts

While there are a number of sources of evidence and studies of the cost impacts of CTC, very few have attempted to include all of the relevant costs outlined in the previous section. The evidence which follows should be viewed in that light.

A second issue is that changes in service levels, whether increases or decreases, are not generally accounted for in the available studies.

The Commission has attempted to mitigate these omissions to some extent by conducting a case study of its own, which is reproduced in appendix F, and by requesting information on contract management costs in the survey of Commonwealth Government agencies described in appendix D.

The main sources of evidence on which the Commission has drawn in analysing cost savings are: publicly available studies on the costs of CTC which are discussed in appendix E; the survey of CTC by Commonwealth budget sector agencies undertaken for the Commission (see appendix D); studies by governments or other bodies presented in submissions to this inquiry; other (sometimes anecdotal) evidence presented in submissions to this inquiry; and the case study of the Defence Department's F-111 aircraft maintenance at Amberley (Queensland) — see appendix F.

Appendix E examines estimates of cost changes from 17 Australian and 24 overseas studies. The Australian studies are summarised in table B3.2. That appendix concluded that the evidence suggests the contracting of government services generally results in ongoing cost savings.

Despite the heterogeneity of the studies, approximately 75 per cent estimated that contracting reduced the costs of delivery. Findings of no savings or cost increases were restricted to only a few of the services examined. Furthermore, the size of any estimated cost increases tended to be smaller (ranging from 0 to 28 per cent) than the range of cost savings (0 to 84 per cent).

Although most studies estimated cost savings, the range and variability of the estimates are large. Such diversity in the size of the estimated cost changes would appear to demonstrate that no useful 'rule of thumb' exists on the size of the probable impact of contracting on the costs of delivery. Rather, it appears each instance contains unique characteristics which influence its success or otherwise (in cost terms).

Table B3.2: Estimates of cost changes from Australian empirical studies

Study	Year	Service(s) & data	Cost change
<i>Before and After Surveys</i>			
Domberger, Farago, Hall and Li	1993	Various services; data from NSW budget sector	-4% to -51% ^{ab}
Farago and Domberger	1994	Various services; data from NSW GTEs	-8% to -46% ^{ab}
Farago, Domberger, Hall and Li	1994	Various services; data from NSW public sector	-1% to -58% ^{ab}
Farago, Hall and Domberger	1994	Various services; data from WA public sector	-4% to -47% ^{ac}
Domberger, Hall and Skinner	1995	Various services; data from WA public sector	+36% to -55% ^c
<i>Cross-Section Surveys</i>			
Rimmer	1988a	Household waste collection; data from Victorian local governments	Average -17%
Australian Chamber of Commerce	1988	Various services; data from SA and Tas. local governments	-9% to -46%
Evatt Research Centre	1990	Various services; data from 460 Aust. local governments	Not provided
Albin	1992	Various services; data from 58 local governments	Not statistically different from zero
Rimmer	1993	Various services; data from a survey of 327 NSW & Victorian local governments, with supplementary data from other sources	-1% to -53% ^d +18% to -45% ^e Not statistically different from zero ^f
Domberger, Hall and Li	1995	Cleaning services; data from Sydney region	-49% to -53% ^g Not statistically different from zero ^h
<i>Case studies</i>			
Rimmer	1988b	Various services; data from Brisbane City Council	-5% to -54%
Rimmer	1991c	Road sealing & street sweeping; data from Glenorchy City Council	-10% to -15%
Hall and Domberger	1995	Cleaning services; data from NSW hospitals	-15% to -30% ⁱ
Jensen and Hall	1995	Radiology services; data from Sydney Hospital	-84%
Jensen and Liebenberg	1995	Government Cleaning Service; data from NSW Government	-31% ^j
Dixon and Jensen	1995	Road maintenance; data from NSW RTA	-34%

- a A small number of cost increases have not been included in these studies. The authors argue that the majority of these cost increases resulted from changed requirements in the contract specifications.
- b Only those services for which there were cost data for at least five contracts are included.
- c Only those services for which there were cost data for at least three contracts are included.
- d Estimates the change in costs for each service using the sample mean.
- e Estimates the change in costs for each service using the sample median.
- f General result of the multiple regression analysis. The only case in which a contracting variable was statistically significant was in waste collection in Victoria, where contracting was estimated to increase costs by seven per cent.
- g These are estimates for cleaning in schools. The school sample was divided into two groups — special schools, which require a higher standard of cleaning, and all other schools. The larger cost saving estimate was found for special schools.
- h Estimates for cleaning in hospitals and offices.
- i These estimates are for recurrent expenditure. Another hospital was also the subject of a case study. While cost savings were also found in that case, the performance was unsatisfactory and the contract was terminated .
- j Projected savings by the third year of operation. This estimate does not include possible redundancy costs.

Despite the wide range of estimates, just over half of the 200 individual services examined yielded estimated cost savings of between 10 and 30 per cent. The remaining estimates were distributed reasonably evenly on either side of this range. Despite institutional and other differences between the United States, the United Kingdom and Australia, the evidence does not suggest substantial variations in the cost impacts across these countries.

Table B3.2 documents the evidence on cost savings from Australian empirical studies. The first three studies are the comprehensive surveys of contracting by New South Wales Government agencies in 1993 and 1994, and the fourth and fifth are similar surveys of contracting by Western Australian Government agencies in 1994 and 1995.

The survey of Commonwealth budget sector agencies undertaken for the Commission (appendix D) found average net cost savings, taking into account contract management costs of CTC, of approximately 16 per cent for responding Commonwealth agencies. Details of the results are shown in table B3.3.

When the sample was widened to include cases where information on management costs was not included, the gross savings from \$28 million worth of contracts (not including Defence CSP contracts) were found to be approximately 18 per cent. Gross savings from \$152 million worth of Defence CSP contracts were found to be close to 36 per cent.

Table B3.3: Net savings from CTC in responding Commonwealth Government agencies

	<i>Total (\$m)</i>	<i>Average (\$000)</i>
Annual fee	25.4 ^a	498.7
Management costs	0.4	7.9
Prior costs	30.9	605.3
Savings	5.0	98.7
<i>Average savings (per cent)</i>		<i>16.3%</i>

a Only those cases where information was provided regarding contract value, contract management costs and prior costs were included in this sample. The full sample size for the survey was \$1.9 billion.

Appendix F provides a case study of a CTC exercise at the Amberley RAAF base. It shows substantial savings, even after many of the transition and transaction costs are included. The study found that the annual personnel-related costs decreased from \$20 million to nearly \$11 million. The inclusion of the CTC-associated costs resulted in the annual cost savings amounting to nearly \$8 million.

Submissions to this inquiry provided a wealth of information on the cost impacts of CTC. The following examples cover a wide range of services at all three levels of government. It should be emphasised that the examples reproduced are generally those reported by government agencies or other participants; they are not the result of independent study by the Commission.

Cost decreases

Commonwealth Government

- The Department of Defence (Sub. 81) stated that, under its CSP program, it has achieved annual total savings of \$52m or 36 per cent of previous costs on contracted out activities. When combined with the efficiencies in activities retained in-house, which have been generated through competition with industry, the savings are estimated to be \$102m or 33 per cent of previous costs.¹ Defence added that a higher level of savings accrue where less prescriptive forms of contract specification are used, where specification allows opportunities for innovation, where competition is high, and where activities are aggregated;
- the Department of Veterans' Affairs (DVA) (Sub. 110) used CTC for the provision of accommodation and treatment at Hollywood Hospital

¹ The difference between these figures and those reported above is due to the difference in time between the compilation of the figures and the inclusion of some different costs.

(Western Australia). The DVA reported a saving of \$123m, increased client satisfaction and reduced waiting times. Savings were stated to have come from better use of capital and reduced staffing. \$192m was saved at Greenslopes Hospital (Queensland) for similar reasons;

- the Department of Employment, Education and Training (DEET) provided an example of CTC in its labour market programs service — it estimated unit costs have fallen through the use of CTC, particularly for English as a Second Language training, down 27 per cent from \$5200 per unit to about \$3800 in 1993-94 (Sub. 230);
- the Department of Administrative Services (DAS) (Sub. 231) estimated cost savings of 30 per cent from the contracting out of its DASFLEET car breakdown service; and
- the Defence Housing Authority reported that the use of contracted building suppliers can result in savings as high as 30 per cent (Sub. 112).

State governments

The results of the general surveys conducted in New South Wales and Western Australia are included in table B3.1 and the literature survey in appendix E. Apart from these reported savings:

- The Victorian Government (Subs. 215 and 289) provided detailed information of the savings achieved by its departments. CTC provided average savings of almost 25 per cent over the initial costs of provision. The calculations included monitoring costs for contracted provision and overhead costs for internal provision. Savings ranged from a low of 9 per cent to a high of 68 per cent from a total contract value of \$139 million;
- Sydney Water reported significant total savings from CTC over a wide range of services. The average cost of meter reading, which was contracted out in 1990, fell from \$2.80 per meter to 77 cents (70 per cent saving) (Sub. 150);
- the NSW Roads and Traffic Authority (RTA) reported 16 per cent savings from the first six months of a pilot road maintenance external contract. During the second six months, the internal team, having undergone significant internal change, was 6 per cent cheaper than the contractor. When the service was retendered, the external contractor won with a price 25 per cent lower than its first contract (Sub. 199);
- the Queensland Corrective Services Commission (QCSC) provided a comparison of costs between its Borallon (privately operated) and Lotus Glen (publicly operated) prisons. The cost comparison, which included apportioned central office overheads, showed that the costs per prisoner per annum were 15 per cent, 7 per cent and 9 per cent lower in Borallon in

the years 1992-93, 1993-94 and 1994-95 respectively, and that costs for both continued to decline over the period;

- Spark and Cannon provided the example of contracted Family Court transcript facilities in Perth which are charged at \$6.90 per page (which can be split between the total number of users), compared with the internal service in other Family Courts where users pay \$6.50 per page (Sub. 71);
- the South Australian Housing Trust reported savings of 58 per cent per receipt from the CTC of its payment agency (Sub. 123);
- the South Australian Department of Roads and Traffic reported savings of between 5 and 20 per cent through CTC (Sub. 123);
- the Civil Contractors Federation (CCF), South Australian branch, provided the example of the contracted provision of the Crystal Brook Bypass (Stage 1), where a contractor had submitted an alternative tender to design and build a steel bridge instead of a concrete one, with a cost saving of 9 per cent (Sub. 118); and
- the Tasmanian Government submitted that various agencies made initial savings from CTC of between 25 and 40 per cent. Later savings were in the range of 20 to 25 per cent (Sub. 108).

Local Government

- The City of Melbourne stated that it had achieved savings ranging from 12 to 33 per cent for a variety of services with savings of \$1.5m from parks and gardens services alone (Transcript, pp. 1466-7);
- the City of Port Phillip provided three examples of cost savings through its use of CTC. It stated that:
 - contracting out of its domestic waste service had saved \$180 000 (20 per cent of the former internal cost) (Sub. 73);
 - the recent tender (won by an in-house bid) of its library services is expected to provide 14 per cent savings over the previous costs through better utilisation of staff, improved management of workloads, work practice reform, improved technology and increased customer service. (Sub. 261)
 - the parks and gardens tender (also won by an in-house team) is expected to provide savings of 30 per cent (\$1.3m) over the previous costs through matching staff to seasonalised workloads, reducing staffing levels, reducing downtime and improving the use of technology and information management systems (Sub. 261);
- Clarence City Council reported that CTC had led to a saving of 40 per cent on the cleaning of public toilets (Transcript, p. 1254); and

- the Local Government Association of Queensland submitted that Townsville City Council had saved 25 per cent of the cost of construction and maintenance of road shoulders throughout the City by aggregating the projects and contracting them out (Sub. 35).

Cost increases

A number of examples of cost increases as a result of CTC were also provided:

- the Department of Environment, Sport and Territories stated that, when it was forced to contract out in Tasmania due to lack of resources:
For the Division, the cost of using IT [information technology] contractors has been at least twice the cost of doing the task in-house. (Sub. 102, p. 3);
- although not an example of a cost increase over an existing service, the Commonwealth Department of Human Services and Health stated that its experience of contracting out complete applications development work for information technology had not been satisfactory and that costs were generally more than originally quoted. The Department attributed this to problems in specifying developing services (Sub. 159);
- The Contracting Casebook provides the example of Sutherland Shire Council's contracting out of refuse collection where the contracted cost was higher (eventually calculated at 19 per cent of the contract price) and the contract eventually failed (Woodland, Swords and Hall 1994); and
- the Evatt Foundation submitted the results of its survey of contracting out in local government, where 30 per cent of respondents reported cost increases in the provision of public works and services when using contractors (Sub. 143).

The ACTU (Sub. 75) also provided a number of case studies of services where they believed CTC had a negative impact on service provision. Most of these concerned service quality or wages and conditions of employees and are therefore discussed in chapters B2 and B4.

In general, the evidence presented here and appendix E suggests that CTC has resulted in cost savings in the great majority of cases but that there are cases where there have been increases.

However, it should be re-emphasised that most of the studies and examples given here did not attempt to include all of the costs which need to be considered to give an accurate assessment of the cost impact of CTC. Furthermore, even those studies which did attempt to include most of the costs recognise that they may not have accurately measured those costs. Indeed many of these studies and examples are open to that criticism. For example, the PSRC (Sub. 214) has taken issue with the methodology used in a number of cases,

particularly the studies by the CTC Research Team and the Department of Defence's calculation of CSP savings, for not always including all relevant costs. While the Commission is also concerned about the omission of certain costs, the more important point is the likely size of those costs and whether they are sufficiently large to negate the net savings otherwise estimated.

B3.3.2 Transition, transaction and internal management costs

A true picture of the cost impact of CTC will not be gained unless the costs of transition to CTC, the transactions costs associated with CTC and all of the costs of internal delivery (including management costs) are accounted for.

As the Australian Association of Social Workers stated:

... optimistic accounts of savings tend to exclude the costs associated with preparing for market testing, organisational restructuring and the transactions cost arising from contract management. (Sub. 23, p. 3)

Equally, it is essential not to neglect the costs associated with managing in-house operations, capital, overheads and many labour costs.

The costs of transition from a non-CTC to a CTC environment should be included in the assessment of costs and benefits of CTC. This matter and, in particular, how to treat redundancy costs in evaluating tenders, is taken up in chapter C5.

By their nature, transition costs tend to be once-off, sunk costs. That is, once incurred they generally do not have to be incurred again but they are usually not recoverable, such as, the costs of establishing separate business units.

Very few studies have attempted to identify transition costs separately. Walsh (1991a) and Walsh and Davis (1993) tried to assess the costs that UK local government agencies had incurred in preparing for competition. After noting the inherent difficulties in doing so, Walsh (1991a) concluded:

The average cost of preparing for competition as a percentage of annual contract size was 10.7 per cent. When spread over the total, as opposed to the annual, contract value preparation costs are 2.5 per cent of total costs. (p. 130)

Walsh and Davis (1993) updated and improved this work, concluding that:

The average cost of preparation for competition (as a percentage of total contract value) was 7.5 per cent of the first year costs and about 1.8 per cent of total contract value given the average length of contracts. (p. 145)

Ascher (1987) included some transition costs, such as severance payments, in the analysis of savings attained through contracting by Wandsworth Borough

Council (UK). Once these costs were included, savings from contracting out and market testing were estimated to be 30 per cent and 23 per cent respectively.

While the general paucity of information indicates that many agencies are not taking these factors fully into account, some are making a considerable effort to do so. For example, the costing principles included in the Department of Defence's CSP manual require redundancy costs, costs of studies and contracting out arrangements and a range of other transition costs to be included in assessments of tenders (Department of Defence 1994). The National Library of Australia also noted:

The Library's experience indicates that cost savings are available through contracting out. The cost-benefit analysis process takes account of all relevant costs including the costs of specifying needs, and drawing up, letting and monitoring contracts. (Sub. 25, p. 5)

The costs of transactions with external service providers and the costs of internal management have also long been recognised as important. Coase (1937) attempted to explain why production takes place within organisations rather than as a network of contracts. He concluded that this occurs because there are costs of using the price mechanism and of organising contracts, which he called 'transactions costs' (contract management costs). He stated that "the costs of negotiating and concluding a separate contract for each exchange transaction which takes place on a market must also be taken into account".

Many transactions costs can be considered fixed costs in the short term but may become variable costs over the longer term as more contracts are negotiated.

Unfortunately, little information regarding these costs is available, although some information was presented to the Commission:

- the Australian Customs Service believed that the savings from its Coastwatch contract would still be significant even when costs of monitoring and management were included (Sub. 187);
- the Department of Veterans' Affairs estimated that the cost of managing its information technology contract equates to less than 4 per cent of the contract value (Sub. 110);
- the South Australian Government stated that costs (not including legal costs) of establishing the EDS contract in that State had been \$4.5m for an \$800m contract (0.6 per cent of contract value) (Transcript, p. 56). It also stated that the costs of monitoring this contract had been included in the calculation of cost savings (Sub. 123);
- the City of Burnside provided the example of a problematic contract where administration costs of 11.5 per cent were considered to be very high (Sub. 136); and

- The Contracting Casebook gives the example of a Pacific Power contracting exercise where eventual savings were estimated to be between \$1m and \$5m, but states that “considering the cost of the contracting project, estimated by Pacific Power to be at least \$500 000, this figure appears to be a rather small saving.” (Aenishänslin et al 1995, p. 39).

The Commission included contract management costs in its survey of Commonwealth Government budget sector agencies (see appendix D). Average contract management costs (transaction costs) of the contracts studied was 2.3 per cent.

When comparing external and internal costs, Coase recognised that there are costs in organising transactions within an organisation which have to be weighed against the market transaction costs. The costs of managing and monitoring internal delivery of services should be assessed.

One example of a comparison of both the external transaction costs and internal management costs was provided by the Queensland Corrective Services Commission (Sub. 239). The comparison of costs between its Borallon (privately operated) and Lotus Glen (publicly operated) prisons include apportioned amounts for central agency overhead costs attributable to both the internal and contracted activities and still show substantial savings from the contracted out operation.

The savings reported by the Victorian Government also included contract monitoring and departmental internal management costs.

The Commission’s case study of the Department of Defence’s F-111 aircraft maintenance program at Amberley (see appendix F), showed substantial savings from the use of CTC even when both transition and transactions costs were included.

The review of empirical studies in appendix E also notes that, although some of the studies reviewed attempted to take account of some of the transaction, transition and internal costs, none covered all of the relevant costs. Indeed, due to the inherent difficulties in calculating these costs, it is unlikely that any study would ever be able to include and attribute all of the relevant costs. The appendix concludes that, as a result, the reported cost changes should be viewed as estimates of the differences in ongoing costs of existing internal delivery and CTC. It notes further that transition costs will vary from one case to the next and it is difficult to assess how significant a bias arises as a result of their omission.

There is limited evidence on the magnitude of transition, contract management and internal management costs. The majority of studies examined would have overestimated any cost savings from CTC because of the omission of transition and management costs. However, the evidence of

the likely size of any omitted costs suggests that their inclusion will not alter the conclusion that in most cases contracting reduces the costs of service provision for public agencies.

In the context of this discussion it is also important to examine the factors influencing the level of transition and transaction costs — and whether they might be reduced over time. For example, there is some evidence that these costs may fall over time. First, because by their nature, transition costs do not recur. Second, transactions costs are likely to fall over time as agencies learn how to manage contracts better. Third, there are likely to be economies of scale as more contracts are managed by the agency.

B3.3.3 The sustainability of cost savings

Another key issue raised with regard to the cost impact of CTC is whether any savings are maintained over time. In addressing this issue it is important to be clear about the base on which the savings are being measured — the cost of internal provision *prior* to contracting (the ‘fixed base’ comparison) or the estimated amount it would cost if currently provided internally (the ‘moving base’ comparison). These concepts are discussed further in appendix E.

For Australia, the evidence on the sustainability of cost savings is limited, largely because the analysis requires cost data over a reasonable time span and this is generally not yet available.

On the small amount of international evidence, however, two tentative conclusions can be drawn. First, cost savings from contracting continue to be obtained over the long term when compared to the fixed base. However, the short-term savings may be higher. Second, cost savings compared to a moving base tend to fall over time, mainly as a result of decreases in the costs of internal provision.

These general conclusions appear to be consistent with the majority of the Australian experience. For example, the Tasmanian Government reported:

The Government Agencies that have experience in contracting out have indicated that cost savings are real and of a significant magnitude. Initial savings varied from 25 per cent to 40 per cent. It is believed that savings are ongoing, but do reduce from the initial position to a maintainable level of around 20-25 per cent. (Sub. 108, p. 17)

While it is uncertain which base was used in measuring the savings from contracting, the outcome in this instance is indicative of the findings from the available evidence. That is, savings do, generally, continue over time.

For savings, compared to a fixed base, to be greater in the short term than the long term, the cost of CTC must rise over time. Two main explanations have

been put forward as to why this may occur, both resulting in contractors submitting initial tenders at unsustainably low prices.

First, many participants expressed concern that contractors would use ‘low-balling’ tactics — that is, contractors would submit unrealistically low bids in an attempt to establish market power by eliminating potential competitors (eg in-house teams). Agencies expressed concern that this would later leave them open to uncompetitive practices by incumbent contractors. This issue is discussed in chapter C4.

Second, the so-called ‘winner’s curse’ noted by Rimmer (1993) can lead to unsustainable tender prices. Due to a lack of information about the real costs of service delivery or undue optimism, contractors may initially submit excessively low bids.

On the other hand, there is evidence that further increases in savings compared to a fixed base are generated for some contracts (see Borallon and RTA examples above) as a result of ongoing competition. However, in many instances, the majority of the achievable savings from CTC may come in the first round of tendering when the major areas of inefficiency in the pre-existing operation are removed. As a result, any further achievable savings on top of those initially obtained may be small by comparison.

When the moving base comparison is used to measure savings over time, the level of savings from CTC often appears to fall. This does not necessarily mean that the cost of service delivery by CTC increases over time. The apparent reduction in savings may be a consequence of the reduced cost of internal delivery of the service which, in turn, can be an indirect benefit of the introduction of CTC. This occurs if the injection of competition into one area of an agency’s operations provides a ‘demonstration effect’ in other areas, which are encouraged to improve their performance.

In this regard, the QCSC submitted:

Contracting out the management of a number of correctional centres and community corrections centres to the private sector/community organisations has proved to be a useful tool for the QCSC in breaking the inertia of the status quo.

Competition from the non-government sector has provided motivation for the employees of the State to address their work practices and productivity improvements in the State run organisations began to be realised within a year of the commencement of private sector contract management of QCSC facilities. (Sub. 148, p. 21)

It would seem that those productivity improvements in QCSC contributed to the recent success of the in-house bid for the design, construct and operation of the QCSC’s Woodford prison.

The available evidence suggests that cost savings from the use of contractors often continue to be realised over time using the fixed base comparison, but may vary from those obtained initially. Savings measured against a moving base of internal delivery costs often appear to fall over time. This may occur as a result of the costs of internal delivery falling. Where this is the case, the competition introduced through CTC may drive the decreases in internal delivery costs.

The types of services

Several studies of the cost impacts of CTC have been criticised on the basis that they have tended to examine only very labour-intensive and/or low technology tasks. Although many of the services studied here and in appendix E may fit these categories and the evidence is that they do generate savings, there is also evidence of savings from relatively high technology or complex services, such as information technology, labour market programs or prison management.

The available evidence is that savings were achieved from CTC in a very wide range of services. Furthermore, the savings available from CTC for substantially similar services also vary widely. For example, waste collection services subjected to CTC produced changes in costs ranging from an increase of 7 per cent to a decrease of 49 per cent. Together these factors make it impossible to conclude that the magnitude of savings from CTC is a factor of the type of service subjected to CTC.

The size of savings from CTC does not appear to be strongly related to the type of service considered.

B3.3.4 Weighing the evidence

The previous discussion examined evidence from studies and submissions on various aspects of cost impacts. None of the evidence or studies covered accurately measured all of the relevant costs. In that respect, the cost savings and increases reported here can only be treated as estimates of the true results.

However, some general conclusions can be drawn. As Associate Professor Quiggin stated:

Although there may be some grounds for questioning the magnitudes of the estimates, there appears to be a general agreement that on average cost reductions are achieved. (Sub. 22, p. 7)

Furthermore, as discussed in appendix E, while the cost impacts from contracting vary across cases, the available empirical evidence does not provide

sufficient information to determine whether service type drives these differences.

The available evidence indicates that, while there have been instances where costs have increased through CTC, it can and generally does reduce the ongoing costs of service delivery for government agencies. The extent of the savings can vary widely.

B3.4 The nature and sources of savings

The wide range of possible outcomes from CTC highlights the need to determine the nature and sources of any savings or efficiencies. Of particular policy importance is whether savings represent efficiency gains or transfers from one group in society to another.

This issue is important because efficiency gains will generate net economic benefits to society from the more productive use of resources. CTC may do this by, for example, stimulating more efficient management and work practices or more efficient use of capital either by in-house teams or external contractors.

In contrast, savings attributable purely to transfers between groups may not result in a net economic benefit to society unless those who receive the resources are able to use them better.

B3.4.1 Efficiency impacts

Agencies may be able to reap productivity gains through the use of CTC if, after the award of the contract, the contracted service provider (whether an in-house team or external):

- has greater management and labour productivity;
- has access to skills which the contracting agency does not;
- can provide economies of scale or use capital more efficiently;
- exhibits innovation; and/or
- improves the flexibility of service delivery.

Management and labour productivity

Management and work practices

The management of agencies, the management of employees and the work practices of employees were often cited by participants as major areas where

CTC could be a useful tool for improving efficiency. The City of Melbourne considered:

For the most part, the poor work practices in our organisation — and I would suggest in many organisations — are a direct result of poor management practices for a long, long time and much of this reform that is occurring in Victoria is as much directed at reforming management of local government as anything else. (Transcript, p. 1477)

The NSW Premier's Department argued:

The sources of savings ... often include inefficient and institutionalised work practices which have built up over decades. These are the cases where the impact of competition is likely to be most felt. (Sub. 199, p. 13)

Skilled Engineering offered a concrete example of where, as a contractor, it had changed the work practices in an organisation:

... the electricity industry in Victoria which is probably a classic in the sense of over 75 years of management union relationships, many, many work practices were built up that were less than desirable in trying to make that industry more effective and efficient for the 1990s and beyond — things like ... overtime, ... manning of power station units when they were out of service, ... [and] sick leave ... All of these things had a significant impact on the productivity of the workforce that was moved from in-house SEC maintenance to contract maintenance work. (Transcript, pp. 1544-5)

Several agencies drew attention to the fact that one of the main benefits of CTC is that it allows public sector management to devote more time to the business of managing organisations rather than getting caught up in the day to day operations. For example, the National Library of Australia stated:

A major benefit of contracting out is the focus on outputs and outcomes rather than inputs. The effect is greater potential for the contracting agency to focus on outcomes and strategic directions rather than management and supervision. (Sub. 25, p. 5)

This view was supported by a large number of other agencies, including the governments of Victoria, South Australia and Tasmania, the City of Port Phillip and the Department of Social Security (Subs. 215, 123, 236, 73 and 138).

The QCSC also attributed the lower cost of the private operators of prisons in Queensland largely to better work and management practices (Transcript, p. 472).

The case study of the Department of Defence's Amberley F-111 aircraft maintenance (appendix F) attributes the savings achieved to a number of factors including re-engineering of workshops, introduction of cellular work teams, changes in the management structure and process improvements.

On the evidence available to it in this inquiry, the Commission concludes that CTC has been associated in many cases with substantial improvements in management and work practices.

Skills base

The ability to draw on skills not available internally was frequently given by participants as a reason for using CTC. The Commonwealth Department of Social Security (DSS) stated:

One of the major benefits of contracting out that has been cited within DSS is the access which it provides to the skills of professional organisations. For example, the aggregate level of knowledge, skills and expertise in some areas of social policy making and research is relatively limited. ... To build up and maintain a vibrant policy and research capability in DSS would mean a sustained investment in human resources over a long period. The capacity of the market to locate and build suitable resources more quickly is becoming more recognised and there would be obvious disadvantages in not attempting to link available expertise. (Sub. 138, p. 12)

The Department of Defence also noted that access to skills was one of the major sources of gain from CTC:

Contracting out has had a significant productivity impact where in-house technology and skills were not available. Improved information technologies and methodologies are now being utilised through contract to achieve more effective and efficient business practices. Additionally, contracting has led to an increased knowledge and skill base as more personnel are trained with the new technologies, with resultant productivity increases. (Sub. 81, p. 17)

Many submissions also raised the loss of skills as a potential problem with CTC, although no examples were given of this occurring. For instance, if the in-house bid is not successful and if the associated employees are not redeployed within the agency, it can lose the accumulated skills of those people. Then:

- it may lose the ability to re-enter the activity later; and
- it may lose corporate memory.

It seems that CTC can have either positive or negative impacts on the skills base of agencies. The overall impact is likely to depend on the circumstances of individual agencies — and how these issues are managed, a matter discussed in chapter C8.

Better use of capital

CTC may provide efficiencies because winning tenderers, whether external or in-house, use capital more efficiently than the previous internal providers, or have access to economies of scale not available to the internal providers. Examples of more efficient use of capital included:

- the Department of Veterans' Affairs observed that the contract suppliers of hospital services were using operating theatres much more effectively and intensively (Transcript, p. 780);

- the City of Port Phillip noted with respect to garbage collection that there were not only savings in the use of labour, but the contractors also used trucks much more effectively than the Council had done previously (Transcript, p. 1607);
- the Australian Customs Service noted that much of the savings from its Coastwatch contract came from economies of scale:
... the Coastwatch contract is not the only business conducted by the successful tenderer (around 30 per cent of the incoming contractor's business, and around 60 per cent of the previous contractor's). (Sub. 187, p. 6) and;
- DSS stated:
One particular example of savings which have been achieved in DSS through contracting out is the 'Click Charge' contract which relates to the Department's office printing and photocopying services ... This arrangement has yielded greater value for money through economies of scale and has streamlined administrative arrangements within the Department, with specific benefits. (Sub. 138, p. 11)

The DSS noted that these benefits had come from absence of up-front purchase costs of equipment, reduced administrative overheads, improved maintenance standards and a more equitable sharing of risk of equipment failure, intangible cost savings resulting from standardisation of machines, increased reliability/functionality/productivity of the new equipment and a rationalisation of DSS equipment levels.

If a service is contracted out, it is also possible that underutilised resources can be disposed of or leased out (as part of the contract or otherwise), leading to sale receipts, savings on maintenance and an improvement in the community's use of capital. For example, in the City of Port Phillip garbage collection contract, the Council was able to lease the vehicles to the contractor (Transcript, p. 1608).

The available evidence indicates that CTC can produce savings due to the more productive use of capital.

Innovation

CTC can allow agencies to harness innovative solutions to policy requirements. Tenders can be specified in such a way as to encourage or allow innovative bids (see chapter C6). Again, competitive pressure can be a major driver of innovation. In the words of the City of Port Phillip:

A further benefit of competitive tendering is the role that competition plays in encouraging innovation. The introduction of competition and open market testing creates an environment in which the need to continually improve the way in which services are provided becomes integral to maintaining the health and viability of the service provider. (Sub. 73, p. 5)

CTC may allow innovation to the greatest extent in those areas where, because of rapid technological change, specialist organisations may have greater and more rapid access to new technologies and knowledge than the agency itself could afford to replicate. Using contractors may allow agencies to avoid having outdated equipment and processes.

If the contract is specified in terms of outcomes instead of processes, it provides an opportunity for more innovative solutions, which the agency itself may not have considered. A good example is the previously mentioned case from the CCF, South Australian branch, of the contracted provision of the Crystal Brook Bypass in South Australia (Stage 1), where a contractor submitted an alternative tender to design and build a steel bridge instead of a concrete one, with a cost saving of 9 per cent (Sub. 118).

Some participants, however, considered that CTC can stifle innovation. For example, the Australian Medical Association (AMA) (Sub. 63) argued that because CTC encourages contractors to squeeze their margins and take a short-term view, incentives for research and development and innovation are decreased. The AMA suggested further that the free flow of information and innovation (eg via medical journals) which has characterised the medical industry would be impeded in an environment where knowledge confers a competitive advantage. This is most likely to be true where there are significant external benefits associated with the dissemination of knowledge.

It has also been suggested that CTC can discourage training, staff development and education which can be important inputs to innovation. DEET said:

The Department is concerned that training opportunities may decrease when large and medium size businesses and public sector agencies contract out functions and services. Generally, it is the larger organisations who provide training opportunities. Small business, with lower overheads and niche markets, may be more successful in winning outsourcing opportunities over the larger businesses. The small business may not have the resources or the commitment of larger enterprises to provide training opportunities. (Sub. 230, p. 17)

The Industry Commission's report on *Research and Development* (IC 1995c) found that, while private sector expenditure on research and development is comparatively low in Australia, it has been increasing in recent years. It noted further that one of the main reasons for increases in research and development spending in Australia in recent years — particularly by private enterprise — was increases in competitive pressure. In this respect, the report stated that competitive pressures provide an important spur to innovation.

CTC can provide cost savings and benefits to agencies in terms of innovative solutions, particularly where it brings access to a wider knowledge base, new ideas and new technology.

Flexibility

CTC has the potential to increase agencies' flexibility where it allows them to choose between different means of service delivery and/or vary levels of resources devoted to particular ends. The DSS explained:

Several areas of DSS have cited flexibility in suppliers as one of the major benefits of contracting out. For example, DSS utilises a corporate satellite television unit to provide information, training, conferencing and other facilities throughout its large and geographically dispersed network. The varying demand for professional production staff would mean that a full time staff complement would at times be underemployed. To keep these staff up to date with advances in their field would also be costly in terms of both investment in time and resources and as such, contracting out for these services provides DSS with the opportunity to choose from among the best current operators in the industry whilst keeping its costs to a minimum. (Sub. 138, p. 11)

The advantage here is that the agency does not have to maintain a permanent resource base to complete infrequent tasks, with implications of wasted capacity and underemployment.

Resthaven, a contracted provider of nursing home services, pointed to itself as an example of increased flexibility through CTC:

Flexibility to change direction in line with needs (aided by greater flexibility in employment practices in non-government sector and size of Resthaven's Human Resources). We have access to over 1000 staff. One week we may need an Italian speaking domestic, the next a male nurse assistant. (Sub. 126, p. 6)

On the other hand, some participants argued that contracting out decreases flexibility. For example, contractors may not be willing to carry out hazardous work or work the extremely long hours involved in some emergency situations (such as flood mitigation which may require people to work 24 hours a day for several days). It may take some time to organise contractors whereas a standing resource base can be drawn on almost immediately. The Local Government Association of Tasmania went so far as to suggest that:

The introduction of outside contractors might lead to evidence of mercenary attitudes in emergency situations like rural flooding or bushfires. Whereas a workforce from the local council, made up of local people would wish to assist the community, a private workforce from several hundred kilometres away, without a vested interest in the local community, may feel justified in retreating to another area, not wishing to become involved. (Sub. 132, p. 13)

Similar problems are raised in the literature concerning CTC and transactions costs. For example, Williamson (1979) noted that, where contractors use very specific capital items (either physical or human), both the contracting agency and the contractor can become 'locked into' the transaction.

Agencies are using various ways to address these concerns (eg length of contract, preferred contractor systems, period contracts, and bundling services) (see chapters C4 to C7).

CTC has increased flexibility for agencies by allowing them to choose between different means of service delivery and to change rapidly the resources devoted to particular ends.

Employment levels

The preceding discussion has highlighted a number of possible sources of productivity gains from the use of CTC. Many of these productivity gains will result in agencies being able to perform specific tasks with less staff. In the short term there are likely to be reductions in employment as a result of CTC. Chapter B4, which discusses employment issues, states that it is difficult to make a conclusive judgment about the overall impact of CTC. Nevertheless, there will generally be a significant reduction in public sector employment associated with CTC. This reduction will not be as great where an in-house team wins the contract.

The reduction in public sector employment is likely to be offset by increases in private sector employment resulting from the transfer of employees to, and the employment of others by, external contractors. There will be some increase in total employment because the economy grows faster as a result of the productivity gains from CTC. Overall, there will be a shift from public sector to private sector employment.

B3.4.2 Transfers

As was noted at the beginning of this section, it is important to determine the extent to which savings from CTC are the result of efficiency gains or transfers between different groups in society.

Transfers are unlike exchange transactions which involve two or more partners, each of whom gives up something of value in the expectation of mutual gain. Transfers involve donors giving something of value to recipients without being fully compensated.

Participants identified a number of ways in which savings from CTC may arise from transfers:

- transfers from employees through reductions in wages and conditions, or increases in effort;
- transfers from one level of government to another through ‘cost-shifting’;

- transfers from governments and tax payers due to tax evasion; or
- transfers from clients through reductions in the level or quality of services.

In practice it is difficult to initiate reform and not make someone worse off, so a proportion of savings will usually comprise transfers. In this chapter, the matters of concern are the extent of transfers and whether they are accompanied by efficiency gains.

Transfers from employees

Many participants raised the concern that any savings from CTC would simply be the result of reductions in wages and conditions of employees or increases in effort without matching increases in remuneration — that is, transfers from employees. For example, the PSRC stated:

The other dimension of employment change is that those who retain their jobs as public employees, after a competitive tendering exercise, and those who may be re-employed by the successful contractor do so on the basis of lower wages and conditions of employment for the same work and often with the intensity of work increased. (Sub. 214, p. 21)

The ACTU added:

When savings have been achieved through contracting out, it has been largely through the reduction of numbers of jobs and/or working conditions, particularly of the lowest paid. (Sub. 75, p. 20)

Associate Professor Quiggin stated:

... many of the apparent gains may in fact represent transfers arising from reductions in wages and working conditions. (Sub. 22, p. 17)

These concerns are also regularly raised in the literature on CTC (see for example, ACTU 1989, Fraser 1992, Paddon 1993).

The empirical evidence on the impact of CTC on wages and conditions is examined in chapter B4. Chapter B4 states that wages and conditions often decline, although some cases of wage increases were provided. Further, chapter B4 finds that where changes occur, they can reflect discrepancies in public and private sector awards or the normal practice in the particular service industry. It may also be indicative of more general labour market trends such as increasing part-time employment and enterprise bargaining.

The argument that cost savings from CTC wholly or mainly result from transfers rests on a number of assumptions.

First, it assumes that there are no significant efficiency gains as a result of CTC. However, the previous section has detailed a number of sources of savings other than transfers and given examples of them. Factors such as better use of capital,

innovation, flexibility, labour productivity improvements and access to skills clearly present opportunities for efficiency gains, even if they are accompanied by some element of transfers.

Moreover, savings are evident across a wide range of areas and services, not just those which are labour-intensive or in areas of low potential for technological innovation. CTC is now used in areas such as information technology, policy advice and management systems where there is clearly scope for productivity gains from sources other than transfers. Some participants suggested that there is little scope for savings from these types of efficiency gains in some activities, particularly low technology or highly labour-intensive activities. However, even in such activities, there can be efficiency gains from better management of resources and tasks.

The evidence from the literature survey contained in appendix E, also indicates that there are many instances where cost savings have come from real efficiency improvements rather than from transfers alone. The household refuse collection case study in appendix C also finds that the main source of savings in that instance is productivity improvements in the use of capital and labour.

Very few studies have attempted to separate efficiency improvements from transfers. One that does is that by Cubbin, Domberger and Meadowcroft (1987). This study estimated that almost 80 per cent of the savings from contracting out of refuse collection in the United Kingdom arose from increases in technical efficiency, with the remaining savings arising from a mix of factors, including changes in vehicle-labour mix, reductions in overhead expenditure and reductions in wages and fringe benefits. However, where in-house teams won tenders, only 40 per cent of savings were estimated to come from improvements in technical efficiency.

Second, even if reducing wages and conditions to private sector levels involves some transfer element, there will be accompanying efficiency gains unless private sector wages and conditions are at a less efficient level than those in the public sector. To argue otherwise where essentially the same tasks are being performed in the public and private sectors at different terms and conditions of employment, is to argue that the public sector terms and conditions are 'right', while those in the private sector are 'wrong'.

Third, it assumes that there are no or few further gains from wage-effort bargains — that is, employees and agencies have little or no incentive to trade any changes in effort for changes in remuneration.

Liebenstein (1966) pointed out reasons why such gains may exist. He posited that, where organisations are not faced with the pressures of a competitive

market (as is the case for most government agencies before CTC is introduced), people and organisations tend not to work as effectively as they could:

In situations where competitive pressure is light, many people will trade the disutility [negative satisfaction or enjoyment] of greater effort, of search, and the control of other people's activities for the utility [satisfaction or enjoyment] of feeling less pressure and of better interpersonal relations. (p. 413)

Such a condition applies equally to management and staff. It does not apply to remuneration and effort factors alone, but also to the exploitation of gains from the other efficiency sources discussed above. Cost savings from having less people performing a function can reflect working more efficiently rather than harder.

Fourth, it assumes that there are few or no circumstances where transfers may be necessary to achieve efficiency gains. This will occur where differences in wages and conditions across sectors result in an inefficient allocation of resources; for example, where wages and conditions for the performance of tasks are out of line with the underlying market wages and conditions and where resources are allocated to inappropriate or unnecessary tasks. Removal of these distortions will result in a more efficient allocation of resources overall.

Such conditions arise because the removal of public sector activity from market disciplines reduces the strength of, or the incentives to react to, market signals (namely prices) which tell managers how to allocate and remunerate resources. Opening activities to competition through CTC introduces those signals and can facilitate the allocation of resources to those who can use them best.

That these assumptions do not always hold is supported by both examples presented in submissions to this inquiry and the empirical literature.

Some participants noted the previous existence of overly generous wages and conditions in areas that have been contracted out. For example, the Australian Association of Social Workers stated in regard to the effects of CTC and other reforms on work conditions:

But there are clearly rorts there. There are clearly practices of the sort of fattening up the beast which are being eliminated. No-one would contest or argue against that surely. (Transcript, p. 1681)

Skilled Engineering stated:

For people moving to contractor employment Skilled's experience is that they are employed at standard award conditions and thus can lose many of the additional benefits which may have been achieved over many years. These added benefits can be industry specific and tend to be an additional cost to the business. In many cases employers tended to regard such benefits as rorts which had been progressively forced upon the employers through industrial activity. (Sub. 69, p. 6)

Cost savings which are the result of transfers from one group in society to another without addressing inefficient management or work practices or the allocation of resources, should not be viewed as efficiency gains. However, there is a great deal of evidence that most of the savings from CTC do represent efficiency gains.

That said, it is clear that, in practice, it is difficult to initiate reform without making someone worse off. Even if gains do outweigh losses, some proportion of savings will comprise transfers. The importance of these transfers is likely to vary on a case-by-case basis. Where there are equity concerns about any transfers, they should be addressed directly, so that potential efficiency gains from CTC can be realised.

Cost-shifting

Another possible source of transfers noted by some participants is cost-shifting. Cost-shifting occurs where the fiscal costs of the provision of services is moved from one government to another. For example, from state-funded hospitals to the Commonwealth-funded medical system or from Commonwealth-supported to state-funded hospitals.

Any reported savings from this source are illusory to the economy as a whole and should not be regarded as efficiency gains. Although there is little evidence on the extent to which existing estimates of savings from CTC would be affected, it is likely to be restricted to those services where more than one level of government has a funding role. From a policy perspective, it is important to note that this problem does not arise from CTC itself, but is a result of existing institutional arrangements (see chapter C2). The best solution to any such problem would be to address these arrangements directly.

Tax evasion

Another possible source of transfers noted by several participants, including the ACTU, PSRC and Associate Professor Quiggin, is tax evasion on the part of contractors. Associate Professor Quiggin noted that the potential for tax evasion may be higher among private sector contractors and their employees than public sector employees, but added that this potential has decreased in recent years due to the introduction of the Tax File Number and stricter compliance laws. To the extent that there are transfers through tax evasion, the problem cannot be attributed directly to CTC, but rather to failures in the taxation and legal system.

Quality reductions

Another possible source of transfers associated with CTC is that of planned or unplanned decreases in service quality which would result in transfers from

consumers. As discussed further in chapter B1, there are examples where quality has gone up, gone down and remained the same after the introduction of CTC. Reductions in quality appeared often to be unplanned as a result of inadequate contract specification, inappropriate contractor selection and poor contract management, including performance monitoring.

Weighing the evidence

The preceding discussion and the evidence presented in B3.3 indicates that there are cost savings available from CTC and that, although care has to be taken in making general assertions, most of these savings are efficiency gains rather than transfers from one group to another.

From this evidence and the literature survey contained in appendix E it is apparent that these savings arise from a number of sources.

There is sufficient evidence to indicate that in many cases the savings from CTC do represent real productivity gains, arising from:

- **the introduction of more efficient management and work practices;**
- **more efficient use of capital;**
- **specialisation and access to expertise; and**
- **access to economies of scale.**

B3.5 Economy-wide effects

In addition to the direct effect on service providers, the more extensive use of CTC has the potential to have wide-ranging effects on the broader Australian economy because of the size of the government sector. The economy-wide effects of CTC will depend on:

- the extent to which governments, including their trading enterprises, increase the use of CTC;
- the cost savings achieved; and
- the extent to which savings represent productivity improvements or reductions in wages and conditions.

The Commission explored the possible direction and magnitude of the economy-wide effects by the use of economic modelling. In that exercise, which is written up in appendix G, it made two different assumptions on each of the variables mentioned above, to give eight separate scenarios.

Under all the scenarios, there were real gains to Gross Domestic Product (GDP), real wages, aggregate employment and exports. For example, the gains to GDP were in the range of 0.3 to 1.7 per cent a year (\$1.3 billion to \$7.3 billion a year in 1993-94 dollars).

The magnitude of the changes depended on the precise assumptions made. After the draft report was released, the Commission invited 27 commentators and practitioners to a workshop to discuss the assumptions and results — and 19 attended (see appendix A for a list of names). Following the workshop, the Commission considers that these assumptions are conservative, but cautions that modelling does not manufacture certainty out of the unknown. Even under the most conservative combination of the assumptions, the modelling shows real gains to GDP of 0.3 per cent a year (\$1.3 billion a year in 1993-94 dollars).

While the modelling indicates that aggregate employment would grow under all the scenarios, it should be noted that initially there may be a reduction in (full-time equivalent) employment of between 12 500 and 74 700. However, as the cost savings from the better use of labour are passed on in the form of lower prices, there would be an increase in demand and, subject to the labour market functioning effectively, employment overall would grow marginally by between 500 and 4400 full-time equivalent jobs.

B3.6 The underlying causes

The preceding discussion has identified some of the immediate sources of efficiency improvements. However, it is not clear that any of these factors by themselves are the underlying sources of any savings from CTC, nor is it clear that particular internal reforms aimed at achieving individual goals, such as increased flexibility, could not have the same effect. In establishing policy positions on the use of CTC or other methods of reform in the public sector, it is therefore important to identify the underlying causes of efficiency gains.

B3.6.1 The effects of CTC and other reforms

One major difficulty which arises in attempting to assess the effects of CTC is that of separating the effects of CTC itself from that of other, concurrent reforms.

The PSRC drew attention to this point:

If services exhibit reductions in cost, but these derive from sources other than the competition involved in competitive tendering or contracting out (such as changes to specifications or organisational changes), then the emphasis for reform should be

placed on the actual changes that produce results, rather than the extension of contracting out. (Sub. 214, p. 6)

Over the last decade and more, many governments and organisations have initiated a large number of reforms. Chapters A1 and C2 describe some of the reforms affecting government agencies in recent years. The effects of past reforms are still being worked through and ongoing reforms are producing yet more changes in public sector efficiency. It is difficult to attribute any performance changes or cost and efficiency improvements to one particular reform, such as CTC. It is likely that at least some improvements are the result of a combination of reforms. This is particularly likely in such cases as the concurrent introduction of compulsory competitive tendering (CCT) targets and amalgamation of councils as is happening in local government in Victoria.

The review contained in appendix E found that no clear conclusions regarding this issue could be drawn from the available literature.

The difficulty in separating the effects of different reform pressures has been addressed in some international reports. The UK Audit Commission (1995) stated:

The increase in efficiency has been caused by a number of influences which are difficult to disentangle. Given increasing financial restraint and the implementation of new technologies throughout the period surrounding CCT, aggregate data does not allow the financial savings to be attributed to any particular cause. (p. 3)

However, the Audit Commission carried on to say:

The discipline of CCT is an important framework for maintaining the drive for greater cost-effectiveness. (p. 3)

While other reforms have also improved efficiency, there are a number of factors which suggest that CTC contributes significantly to the efficiency improvements which have occurred.

First, the fact that a wide range of agencies in different circumstances have experienced cost savings from the use of CTC in a wide range of services suggests that CTC is a significant contributor to savings.

Second, several agencies have indicated that savings achieved from CTC are additional to savings from other reforms. The City of Melbourne stated that its 20 per cent cost savings from CTC were on top of the 25 per cent cost savings achieved from other organisational reforms in the run-up to CTC (Transcript, p. 1456). Indeed, it stressed the relationship between the internal reforms and moving to competitive tendering:

Based on the Council's experience, successes in implementing internal reforms, work place restructure and other efficiency measures have been fundamental for the introduction and successful implementation of contracting out. (Sub. 89, p. 2)

The case study of garbage collection at the City of Oakleigh, where a two-stage process was introduced with internal reform preceding CTC (discussed in appendix C), provides an example of CTC yielding productivity improvements beyond those achieved by internal reform. In this case, substantial savings were achieved at both stages of the process.

These experiences seem to be shared by a number of agencies.

In some cases it is difficult to separate the savings from CTC from those attributable to other reforms, such as enterprise bargaining and local government amalgamations. All the same, agencies across the country have experienced savings from CTC, which suggests that at least some of the savings can be directly attributed to CTC.

B3.6.2 Competition and contestability

The driving force behind many of the potential areas of gain appears to be competition or the threat of competition. Many contractors operate in a competitive environment that provides incentives for efficiency and, when CTC is introduced, in-house teams also find themselves operating in a competitive environment. That is, it is the contracting process itself, when it is conducted in a competitive market, which provides the ongoing incentive for efficiency.

Chapters C4 and C5 describe some of the effects of competition and give details of how effective competition can be facilitated.

There are ample examples from the Department of Defence, the City of Melbourne and other organisations where in-house bidders have performed better than external tenderers and produced savings. This suggests that competition itself is a strong force for productivity improvement. For example, the City of Melbourne said:

Where internal providers have been successful in winning their bid, they have frequently done so on the basis of further changes in work practices or conditions of employment which have increased their productivity and reduced the Council's costs. (Sub. 89, p. 20)

The example of a pilot road maintenance program given in box B3.1 illustrates the beneficial effects of competition arising from contracting.

Box B3.1: NSW Roads and Traffic Authority (RTA) — road maintenance

In 1990, the RTA began assessing the options for road maintenance contracting. It decided to undertake a pilot contracting project for the road network to assess the feasibility of contracting and to gain experience.

The two year contract was awarded to Boral Asphalt which was the lowest cost tenderer satisfying all other criteria and began in July 1991.

The RTA compared the performance of the contractor with the in-house team. There was no statistically significant change in road condition in any of the networks over the period of the pilot road maintenance project and no evidence of any difference between the quality of the work performed by Boral and that of the RTA work force. Over the first six months Boral was 16 per cent cheaper than the RTA. During the second six months, Boral's costs were 6 per cent above those of the RTA, as the RTA work force reduced its costs.

The RTA increased the size of the maintenance contract for the remaining 12 months and awarded it to the existing contractor. At the end of the two-year period, the contract was retendered. The contract was awarded to Boral, which was the lowest of the six tenders received. Boral's tender was approximately 25 per cent lower than the price it had bid the first time around.

Source: Dixon and Jensen (1995)

A further example (noted previously in this chapter) was provided by the QCSC where external contractors provided the impetus for improvement in internal performance to the point where a later contract (for the new Woodford prison) was won by an in-house team.

Many participants stressed the point that the threat of competition is a powerful force in encouraging productivity improvements in internal operations. The Victorian Government commented:

Competitive tendering or the threat of competition (via periodic market testing of contracts) have strengthened the incentives for contractors to satisfy client and customer demands for cost-effective services that meet specified performance and quality standards. (Sub. 215, Executive Summary)

And the Hobart City Council said:

That's probably ... a cultural and work practice change. ... right throughout the organisation now, there's a prevailing view that you don't have a job for life in local government. Certainly that has made people start to focus on changes in terms of productivity they need to make in order to make themselves competitive. (Transcript, p. 1260)

The NSW Government provided an example:

In the case of hospital 'hotel' services such as cleaning and catering the possibility of competition has acted as a strong influence for cost reduction. Under a 'cost-effectiveness agreement' these activities in hospitals do not have to be market tested if comparable in-house efficiencies can be achieved. As a result, support services such as cleaning and catering are now being provided at savings of \$80 million per annum over the case in 1989-90. (Sub. 199, pp. 12-13)

The City of Melbourne pointed out some information from overseas research in this respect:

The Council's research of overseas experience shows that where an in-house bid is encouraged, the level of savings achieved is significantly higher than where no in-house bids exists. The Citizen's Charter Market Testing Report, reviewing the performance in the United Kingdom indicates a 27.8 per cent savings where in-house bids were included and only 14.4 per cent savings where no in-house bids were involved. These results confirm that the inclusion of in-house bids will lead to a higher level of competition and will force the external market to produce very competitive pricing. (Sub. 89, p. 10)

In short, it is likely that the greatest benefits will arise from CTC where there are sufficient participants in the CTC process to ensure a reasonable level of competition or contestability. This matter is discussed in detail in chapter C4.

It is difficult to isolate the underlying sources of savings from CTC. However, the fact that substantial savings have been achieved even after internal reforms have been implemented and where either in-house or external bidders win contracts, indicates that it is the competition and contestability introduced by CTC which is the overriding driver of savings.

B3.7 Conclusion

The available evidence on the cost impacts of CTC suggests that CTC has in the past provided substantial savings to agencies. It is also clear that savings cannot be guaranteed in every case.

The evidence also suggests that there is potential for some of the savings from CTC to be the result of transfers, but that the great proportion of the savings documented are more likely to come from real efficiency gains.

The sources of efficiency gains include improvements in management and work practices, wider access to skills, more efficient use of capital, stimulation of innovation and increased flexibility in service delivery.

From a policy viewpoint, it is also important to identify the underlying impetus for all of these factors. There is strong evidence that it is the competition introduced to government service delivery which provides the driving force for improved performance.

B4 EMPLOYMENT, WAGES AND CONDITIONS

B4.1 Introduction

The impact of competitive tendering and contracting (CTC) on employees and their wages and conditions received much attention in this inquiry. Some participants argued that the savings derived from CTC are achieved mainly at the expense of employees, primarily through job loss and reductions in wages and conditions. Others disagreed with that view.

This chapter examines the impacts of CTC on:

- employment;
- employee wages and conditions;
- other employment aspects such as career development and job security; and
- particular groups of employees.

B4.2 Employment

Throughout much of the 1980s and 1990s, there has been a concerted effort by government at all levels to improve the effectiveness of the public sector. The size of government and its efficiency relative to the private sector have been subjects which have received particular attention. Many of the public sector reforms which have been introduced to improve the efficiency of government, have had the effect of reducing levels of public sector employment. CTC is one example of the reforms which have generally had this effect.

Making judgments about the overall impact of CTC on employment is difficult for several reasons:

- reductions in employment from CTC are sometimes difficult to separate from those which result from other reforms such as council amalgamations, general downsizing, changed functions and the introduction of more efficient management and work practices;
- it is necessary to take into account the second round and subsequent impacts on employment;
- it is sometimes difficult to distinguish between the effects of CTC and general labour market trends, such as greater use of part-time labour; and

- the impact is likely to differ between categories of employees, for example, depending on age, gender, occupation and industry.

B4.2.1 Public and private sector employment

The impact of CTC on total employment depends on the specific impacts on public sector and private sector employment.

Public sector employment is likely to decrease as a result of CTC for two main reasons. First, the introduction of competition is likely to place pressure on government agencies (and private sector bidders) to use labour more productively than under previous service provision. This may mean that less workers will be needed to provide the same level of government services. If these savings are not used to expand other government activities, there will be a decrease in public sector employment. Second, where services are contracted out, there will be a reduction in employment in the public sector. However, the effect on total employment will include increased employment in the private sector, both in the delivery of government services subjected to CTC, and in other areas of the economy as a result of the economy-wide effects of CTC.

Where labour costs represent a large portion of the total costs of providing a service, reductions in employment are likely to produce significant cost savings. The South Australian Government observed:

Seventy to eighty per cent of hospital expenditures are on salaries and wages and it is inevitable that efficiency dividends gained by outsourcing in these facilities will flow from lower staff numbers and different work practices for those who remain. (Sub. 123, p. 28)

Serco commented in similar vein:

Looking at contracting generally, the numbers that are reduced tend to equate to the level of saving achieved because most of our costs are in people. So if we talk about a 30 per cent [saving] that's possible on average, then you're talking about a 30 per cent staff reduction. (Transcript, p. 1101)

Even where the in-house option is successful, there is likely to be a reduction in the number of employees. For example, employment was reduced in the Victorian City of Port Phillip's parks and gardens unit by around a quarter when tenders for services were won in-house (Sub. 315). Table B4.1 contains more examples of the impact on total staff employed by public sector agencies where the in-house option was successful.

These examples suggest that the introduction of competition through CTC is likely to place pressure on in-house teams to deliver a given level of services using less labour. Consequently, where the savings are not used to expand other

government activities, there will be a reduction in public sector employment where provision is retained in-house.

Table B4.1: Impact of CTC on employees when in-house bids succeed

<i>Organisation</i>	<i>Total staff involved</i>	<i>Retained in in-house option</i>	<i>Redeployment</i>	<i>Redundancies</i>
Department of Defence ^{abcd} Defence Science and Technology Organisation, Salisbury (science support)	142	142	0	0
National Supply and Distribution Centre, Moorebank (warehousing, maintenance and distribution)	(inc 21t/v) 820	385	298	116
Amberley (F-111 aircraft maintenance)	356 ^e	214 ^f	50	113
City of Melbourne Aged care services	69	43	4 ^g	15
Waste Management Services	67.5	61.5	0	6

a Includes civil and military personnel except where indicated otherwise.

b Redundancies do not include temporary staff who do not receive redundancy packages and are the first to go.

c Ex-Defence staff who joined contractors were not necessarily exclusively from that particular area pre-CSP.

d Positions before CSP numbers include permanent staff, temporary staff (t) and vacant positions (v).

e Included 3 Supplier Field Maintenance staff.

f Several of these positions were created within the in-house option following CSP.

g Two of these staff were previously team leaders and are now Care Managers, whilst the other two were Recreation Workers and are now Community Liaison Officers.

Sources: Appendix F, Department of Defence (Sub. 232) and information supplied by the City of Melbourne

Where service delivery has been transferred to the private sector, there has often been a significant decrease in public sector employment. This is evident in table B4.2 which shows the numbers of staff affected by contracting out in a number of agencies and the effect on their employment, including transfers to private sector contractors.

Table B4.2: Impact of contracting out on employees — various agencies

<i>Organisation</i>	<i>Total staff involved</i>	<i>Transfer/joined contractors</i>	<i>Redeployment</i>	<i>Redundancies</i>
Department of Veterans' Affairs				
National Computer Centre	33	0 ^a	15	18
RGH Hobart	350	317	0	33
RGH Concord	2714	2484	7	223
RGH Hollywood ^b	1000	280	78	530
RGH Heidelberg ^b	2000	1430	55	424
RGH Greenslopes ^b	1300	174	58	1000
RGH Daw Park ^b	900	670	30	140
Department of Defence^{cd}				
Puckapunyal base support ^e	360 ^f	30	150	87
RAAF Williams base support	53	14	22	31
ADFA Canberra catering	118 ^g	16	57	57
Moorebank Base Administrative Support Centre	122 ^h	na	77	32
Nowra Aircraft component maintenance	166 (inc 49 Core)	i	105 ^j	12
Salisbury Base Support Services property ops & material dist. ^k	79	11	2	77
South Australian Government				
Pipelines Authority	118	107	7	4
Modbury Hospital	709	351	89	269
Department of Primary Industries (Forwood)	478	292	19	167
Department for Correctional Services (Mt Gambier prison)	20	5	4	11
Trans Adelaide- Northern route ^l	199	39	77	83
Victorian State Government				
Metbus services	450	343 ^m	na	na
SECV				
Maintenance	3000	975	na	na ⁿ
Melbourne Water				
Mechanical and electrical maintenance	151	89	35	27
Civil maintenance	729	270	247	212
City of Melbourne				
Road verge & median strip mowing	4	0	4 ^o	0

Table B4.2: Impact of contracting out on employees — various agencies (cont.)

<i>Organisation</i>	<i>Total staff involved</i>	<i>Transfer/joined contractors</i>	<i>Redeployment</i>	<i>Redundancies</i>
City of Morwell				
Home & community care	45	23P	0	22
Port Phillip City Council				
Waste management	25	15	0	10

- a Of the 18 employees who accepted redundancy payments, 17 were subsequently employed by the contractor.
- b Remaining staff were employed on fixed term contracts which were terminated at the time of transfer.
- c Defence figures are as at July 1995 and include civil and military personnel except where indicated otherwise. Defence also use the clean break strategy in dealing with excess staff. As a result, the number of redundancies includes those who have transferred to the contractor.
- d Ex-Defence staff who joined contractors were not necessarily exclusively from that particular activity pre-CSP.
- e 8 staff were still on strength/in process as at July 1995 and not allocated to either redundancy or redeployment.
- f Includes 80 temporary and 35 vacant positions.
- g 4 military staff remain in the area.
- h Includes 13 temporary positions.
- i British Aerospace (Nowra) now employs 67 (90 per cent ex-Navy) including 24 who transferred at commencement of contract plus others who joined later and core uniformed naval employees retained for their skills.
- j By deduction (166-49-12), 105 were redeployed or posted.
- k No military involved.
- l Actual figures may vary as some employees still undecided (South Australian Government, Sub. 123, attachment).
- m National Bus Company (Sub. 217) disputes claims by the ACTU (Sub. 75) that only 250 were employed.
- n Skilled Engineering (Sub. 69) suggested that most of the staff who were not transferred to the contractor left the SECV under a voluntary departure program.
- o Reassigned to other duties in the same work area.
- p Includes 6 casual carers that were not obliged to be employed.

Sources: Department of Defence (Sub. 232), Department of Veterans' Affairs (Sub. 110), ACTU (Sub. 75), Silver Circle (Sub. 223), Skilled Engineering (Sub. 69), South Australian Government (Sub. 123), Domberger and Hall 1995 and information supplied by the City of Melbourne and Melbourne Water

In most cases reported in table B4.2, at least some — and at times a significant proportion of — displaced employees were hired by the contractor. For example, over 90 per cent of employees at the Repatriation General Hospital Concord were subsequently employed by the State Government in the transfer by the Department of Veterans' Affairs (DVA).

The large numbers of public sector staff employed by the contractors reflects the desire of contractors to make use of the existing skills and knowledge of those employees. Some agencies which have engaged in large scale contracting, such

as the DVA, have sought to develop policies encouraging the transfer of staff (see section C8.4).

Skilled Engineering supported:

... re-employment of former employees with the new contractor as this ensures continuation of skills for the work, minimal disruption to people and continuity of work. (Sub. 69, p. 7)

Notwithstanding this, Skilled Engineering stated that, for the 38 maintenance contracts it had won with the public and private sectors, contracting out resulted in a significant loss of jobs. On average, the contractor could provide the same service with 42 per cent less staff than the in-house provider (Sub. 69). The number of staff transferred to the contractor was often higher where contracting occurred in the public rather than private sector.

The Australian Manufacturing Workers' Union (AMWU) stressed the role of enterprise bargaining in reducing the dislocation of the workforce resulting from CTC:

... in those places where functions have been contracted out successfully, and with minimum dislocation, an enterprise agreement has been negotiated prior to the changeover. This occurred for instance with the RAAF's helicopter maintenance program at Fairbairn (ACT), and likewise with the contracting out of the Melbourne Water's maintenance. (Sub. 299, p. 7)

In addition to employing staff transferred from the contracting agency, private sector contractors may employ extra staff from other sources. For example, since the City of Morwell awarded its contract for homecare services, Silver Circle has employed an additional 27 staff in the Morwell area and an extra 50 in the Gippsland region (Sub. 223).

In the sale of the repatriation hospitals by the DVA, a significant proportion of staff were employed from other sources as well as directly from the pre-existing staff. For example, at Hollywood Hospital, 281 staff transferred from DVA whilst 314 came from other sources. And, in the sale of Greenslopes, 174 transferred from DVA whilst 461 came from other sources (Lyon 1995).

CTC may also create new positions in the private sector where a service is being contracted out for the first time. The Employment Service Regulatory Authority (ESRA) is a new organisation involved in the contracting out of case management services provided to the long-term unemployed. It stated that this initiative will:

... create a number of jobs in the case management industry in the private and community sectors. There may be some corresponding impact on staff resources in the Department of Employment, Education and Training, though it needs to be noted that

the White Paper included a commitment to strengthen the CES. ... This should ultimately lead to an increase in aggregate employment. (Sub. 139, p. 7)

In short, these examples highlight some of the initial effects on employees where functions are transferred to external contractors. They generally suggest that there will be a reduction in public sector employment. However, this will be, at least in part, directly offset by increased private sector employment, primarily as a result of public sector employees transferring directly from the agency to contractors but also from other sources.

B4.2.2 Redeployment and redundancies

Redundancies have been used as a means of achieving reductions in public sector employment. Provisions governing severance entitlements and benefits exist at both the state and Commonwealth levels and in local government awards.

Redundancy payments can represent a significant transition cost associated with the CTC process (see chapter B3). Many government agencies have sought to either redeploy or transfer staff to contractors as a means of minimising these costs, as well as to preserve the employment status of their former employees. For example, the NSW Treasurer indicated in his June 1995 Financial Statement that “preference will be given to private sector proposals that provide employment opportunities for existing staff” (New South Wales Government 1995, p. 51).

Redeployment has been a feature of CTC, particularly at the Commonwealth level. However, the ability to redeploy staff depends on several factors. First, the availability of positions within the agency and the public service. In the case of small councils, opportunities for redeployment may be limited. Second, where entire functions are contracted out, there may no longer be similar employment positions in the same field. The Commonwealth Public Service Commission (PSC) acknowledged that:

In many cases there are very few, if any, jobs left in the APS [Australian Public Service] where people with the skills and experience to perform the contracted out function can be employed. (Sub. 74, p. 6)

In relation to the sales of the Repatriation General Hospitals Hollywood and Greenslopes, the DVA acknowledged the difficulty of redeployment:

We knew that redeployment opportunities for health professionals and blue collar staff were non-existent in the APS. Clerical staff also had limited redeployment opportunities. Obviously, we needed to maximise the opportunities and provide opportunities outside the APS as well as inside. An objective therefore was to minimise

the number of surplus staff seeking APS redeployment without adding to the cost of redundancies. (Lyon 1995, p. 8)

This limits the extent to which redeployment may be an effective means of finding alternative employment for excess staff.

The widespread offering of redundancy packages raises several issues in relation to CTC. First, where employees accept a redundancy package and then subsequently obtain employment with a contractor, concerns of 'double dipping' arise. This issue is dealt with further in chapter C8.

Second, there are concerns over what happens to employees after they are made redundant. Some participants argued that the employees that have the best employment prospects are most likely to accept an offer of redundancy. For instance, the Tasmanian Government (Sub. 108) stated that, in its experience, the more talented staff often chose to take voluntary redundancy packages and secure alternative employment. However, there are likely to be others with poorer re-employment prospects.

What happens to employees made redundant?

The Commission was able to obtain very little information on the experiences of public sector employees made redundant as a result of CTC. This makes it difficult to assess the extent to which, for example, employees experience periods of unemployment, or must make a significant career change, as a result of CTC.

The DVA surveyed the attitudes of ex-Repatriation General Hospital Hollywood staff twelve months after the sale. Of the 480 staff located who accepted voluntary redundancies, 220 responded to the questionnaire. Seventy seven per cent of people who intended to re-enter the workforce were successfully employed (Lyon 1995).

Some information is available on what happens to redundant workers generally. Although it does not strictly reflect the impact of CTC on redundant workers in public sector agencies, it does reflect the labour market experiences of redundant workers, particularly their likelihood of re-employment.

A Victorian survey (ABS 1993) examined the experiences of retrenched workers and workers who accepted redundancy packages in the three years to October 1993. It indicated that over ten per cent of those surveyed had been made redundant in this time. Nineteen per cent of staff retrenched were from the public sector, the majority of them (73 per cent) having been employed in that job for a period of five years or more. The main reason reported for retrenchment was 'lack of enough work/job cuts'.

The survey indicated that half of those retrenched were currently employed (see table B4.3). However, it should be noted that the survey was conducted during a period of high unemployment in Victoria.

Table B4.3: Employment status of retrenched workers^a, Victoria, 1993

<i>Employment status</i>	<i>Number</i>	<i>Percentage</i>
Employed	124 100	51
Unemployed	80 300	33
Not in labour force	39 900	16
Total	244 400^b	100

a Includes those who were made redundant or accepted redundancy packages.

b Column does not add up due to rounding by ABS.

Source: ABS 1993 Cat. no. 6266.2

Further information from this survey (ABS 1993) on the impact of retrenchments suggested that:

- persons working in the manufacturing, wholesale and retail trade, and 'other'¹ industries were more likely to be affected;
- tradespersons, labourers and related workers were most affected whilst para-professionals, managers and administrators were least affected; and
- the most common difficulties reported in getting a job since retrenchment were that there were no jobs in the line of work, no jobs at all, or employers thought that they were too old or too young.

There have also been a series of studies which have examined the impact of redundancy on workers resulting from specific plant closures (Wooden 1987²). Again, this information does not specifically relate to redundancies resulting from CTC. However, it is indicative of the general impact, particularly the likelihood of reemployment and the duration of any unemployment. The studies suggested that employment was usually found quickly, although a sizeable minority spent prolonged periods looking for work. A recent New Zealand study also suggested that the majority of redundant workers quickly find new employment. However it should be noted that the survey sample consisted of workers who had received out-placement assistance from consultants at the time of redundancy, and that labour market arrangements in New Zealand differ from those in Australia (Deloitte Touche Tomatsu 1994).

¹ 'Other' industries include electricity, gas and water, communication, public administration and defence.

² Wooden 1987 provides a comparison of studies conducted in Australia and overseas on the impact of redundancy on workers.

The limited information available suggests that, where workers are made redundant as a result of CTC (or for any other reasons), there is a high probability of their finding alternative employment in the 12 months following redundancy. However a sizeable minority may have difficulty in obtaining work.

B4.2.3 Economy-wide impacts

While CTC will initially result in a decline in employment within particular agencies and the public sector, it is also necessary to consider the second and third round effects of CTC. Many people are likely to find alternative employment (see above). Moreover, efficiency improvements resulting from CTC will, over time, reduce costs, lower prices, and/or induce higher output.

Several participants highlighted the stimulus that improved efficiency may provide for employment. For example, the South Australian Government stated that in relation to the contracting out of IT services:

The net employment impact is an estimated increase in excess of 1000 positions comprising staff to be recruited by EDS and positions to be created in other IT firms as industry growth is stimulated. These direct impacts are additional to the flow on effects and employment growth stimulated indirectly through industry linkages. (Sub. 123, p. 9)

The Civil Contractors Federation, Queensland branch, acknowledged:

... if the benefits of competition are achieved, greater funding should be available to be expended thus creating more employment which would be taken up by the needs of the private enterprise system. (Sub. 95, p. 4)

United Kingdom research (Centre for Public Services 1995) challenges the employment generation effects of CTC. It suggested that the indirect costs of CCT to the central government, such as through increased welfare payments, greater training costs and reduced taxation revenue, were double the direct savings achieved by local government. After examining this research, the Commission considers that it does not make a complete assessment of the costs and benefits of CTC. It appears to consider only the initial impacts and not the second and subsequent impacts of CTC on employment (see appendix E).

In appendix G the Commission has explored the possible direction and magnitude of the economy-wide effects of the increased use of CTC by governments and their trading enterprises by the use of economic modelling. One of the conclusions is that, while increased CTC will lead to a significant shift in the structure of employment, it will also lead to marginal growth in employment overall.

The Commission considers that it is difficult to make a conclusive judgment about the overall impact of CTC on employment. Nevertheless, there will generally be a significant reduction in public sector employment associated with CTC. This reduction will not be as great where an in-house team wins the contract.

The initial reduction in public sector employment is likely to be offset, to at least some degree, by increases in private sector employment resulting from the transfer of employees to, and the employment of others by, external contractors.

Over time, CTC is likely to lead to some increase in total employment.

B4.3 Wages and conditions of employment

The impact of CTC on wages and conditions of employment was a major concern for many participants. While there is a lack of comprehensive Australian data on this matter, certain observations can be made. Experience in other countries also provides some insights, though they cannot be strictly applied to Australia due to differences in the institutional structures of labour markets and in CTC policies.

Evidence from the UK and the United States is unclear about the impact of CTC on wages and conditions. In the UK, the Labour Research Department (1987) indicated that there had been a reduction in wages and conditions, although this was often associated with an increased trend towards the use of part-time labour by contractors.

Ascher (1987) argued that CTC in the UK had resulted in a change in conditions of service, particularly as “public sector arrangements for holiday and sickness pay, disciplinary procedures and pensions are better than those offered by many contractors” (p. 110). Ascher also indicated that employees’ wages and conditions tended to be reduced even if an in-house bid team won the tender.

However, Cubbin, Domberger and Meadowcroft (1987) found no evidence of a reduction in wages and conditions resulting from the tendering of refuse collection in the UK. Walsh (1991a) reaffirmed this view, arguing that the main impact of CTC had been on staffing levels rather than pay and conditions.

The UK Equal Opportunities Commission (1995) undertook a survey of four services subjected to compulsory competitive tendering (CCT) in the UK. It suggested that pay rates in the predominantly male refuse collection service increased during the first round of tendering. However, pay rates did not increase in any of the case studies in the predominantly female catering and

cleaning services, and in some cases declined, particularly where part-time workers were predominant.

In the United States, Stevens (1984) found that higher costs of service provision for local government were not attributable to differences in wages and fringe benefits paid by contractors and municipal agencies. Wages were generally 5.5 per cent higher in local councils, while fringe benefits were generally 5.2 per cent higher for private sector contractors.

In Australia, the Evatt Research Centre (1990) surveyed Australian councils about the perceived advantages of CTC. Less than 4 per cent of respondents indicated that lower labour costs were an important advantage, whilst less than 10 per cent cited lower labour overheads as important.

Rimmer (1993) surveyed councils in NSW and Victoria which had been involved in CTC. Only one per cent of NSW councils and no councils in Victoria said that they had reduced wages and salaries in association with CTC. Rimmer concluded that “reducing remuneration is not perceived by Australian local councils as a major advantage associated with contracting” (p. 237).

The ACTU (Sub. 75) argued that savings through CTC have been achieved largely by cutting the number of jobs and/or working conditions, particularly of the lowest paid. It provided several examples, which are summarised in tables B4.4 and B4.5.

In the case of the City of Melbourne, it should be noted that reductions in wage rates were negotiated to improve the competitiveness of the in-house team and to avoid employees being made redundant. Similarly, in the case of the City of Port Phillip’s parks and gardens service, over award payments were partially eliminated under a local work area agreement.

The Victorian branch of the Municipal Employees Union (appearing at the public hearings as part of an ACTU delegation) stated that in Victorian local government:

90 per cent of the tenders that we have been involved in, 90 per cent of those members have had to take a wage reduction or condition reduction just to even get themselves into a competitive position. (Transcript, p. 1176)

The contracting out of cleaning in NSW Government schools was cited by participants as an example of employees being made worse off (NSW Teachers Federation, Sub. 131 and Ethnic Communities Council of NSW (ECC), Sub. 90). Under CTC, employees were claimed to face a greater workload as a result of a substantial decrease in the average number of weekly cleaning hours per school since the end of 1990. The ECC stated that cleaners previously employed by the NSW Government Cleaning Service had experienced reductions in their terms and conditions of employment.

Table B4.4: Impact of CTC on pay rates and hours of work

<i>Organisation/Service</i>	<i>Pay rates</i>		<i>Hours of work</i>	
	<i>before CTC</i>	<i>after CTC</i>	<i>before CTC</i>	<i>after CTC</i>
Morwell City Council	na	award rates maintained for 18 months	na	no change
City of Melbourne/ Aged services	\$11.88/hour	\$9.50/hour	20 hours min ^a	no minimum ^a
City of Melbourne/ Waste management	\$14.17/hour	\$12.88/hour	38 hours, RDO ^b	38 hours, no RDO
Victorian State Government/(Metbus service)	\$487.80 a week (base rate)	\$449.90 (base rate minimum) to \$520.40 (base rate maximum)	38 hours a week	38 hours a week ^c
Junee Private Prison	\$30 285	\$27 756	38 hours a week	40 hours a week

na Not available.

a The spread of hours that the direct care staff now work is from 6am to 10pm seven days a week to a maximum of 38 hours a week as compared to before tendering of 6am to 6pm. Hours worked beyond this allow for the payment of overtime.

b Rostered day off

c Employees obtain one RDO every four weeks worked.

Sources: ACTU (Sub. 75), Public Transport Union (Sub. 216), National Bus Company (Sub. 217)

A school cleaning survey conducted by the NSW Teachers' Federation also indicated other negative impacts on workers. For example, 34 per cent of respondents thought that cleaners were not fairly treated by the contractor with respect to industrial conditions. Cleaners in 45 per cent of responding schools were also doing extra unpaid hours so that the work could be completed (Sub. 131).

In addition to the above evidence, the Commission was told of Australian examples where employees' wages and conditions stayed the same or increased following CTC.

In the case of the transfer of staff following the outsourcing of the Victorian Department of Finance's Viccomputing division, Hansen Corporation stated:

Offers of employment were made on the basis of comparable terms and conditions to ensure that no transferring employee was disadvantaged financially or was forced to

accept inferior conditions of employment to that offered by the Victorian Government. (Sub. 304)

In the City of Port Phillip (Vic), the remuneration and conditions of the successful in-house library team were unaffected (Sub. 315).

Defence stated that the Commercial Support Program was:

... one of the major efficiency measures which have contributed to improvements in wages and conditions (across the Department) under productivity based pay rises. In-house teams have been successful in some 30% of CSP decisions but in no case has there been any reductions in wages and conditions for the members of those teams. (Sub. 323)

Ferrier Hodgson Corporate Advisory argued that employees' remuneration was considerably higher once workers moved to the private sector (Transcript, p. 1574).

Following the sale of repatriation hospitals by the Department of Veterans' Affairs, some doctors were able to receive higher remuneration:

Doctors in private sector hospitals are not generally employed but engaged on a fee for service basis. Successful specialists at Hollywood were able to obtain redundancy and then generally receive higher remuneration from fee for service arrangements. (Lyon 1995, p. 16)

It is possible that much of the initial focus of CTC has been in those areas where wages and conditions of public sector employees are well above those of similar private sector employees, and that at aggregate level the difference between the two sectors is less. A recent Australian study suggested that, after controlling for differences in average worker skills, industry effects, and occupation effects, there is not a significant difference between earnings of public sector and private sector employees (Borland and Lye 1995). If this is the case, then the introduction of CTC to other public sector activities may not lead to a significant change in wages and conditions.

As to the impact on conditions of employment such as superannuation and leave entitlements, table B4.5 suggests that there have been reductions in most cases reported to the inquiry, although employees of the City of Melbourne experienced no change.

The limited information available suggests that wages and conditions for those undertaking a function are often lower after the introduction of CTC. However, some examples were provided of higher wages.

Table B4.5: Impact of CTC on superannuation and leave entitlements

Organisation/ Service	Superannuation		Long service leave		Annual leave		Sick leave	
	<i>before CTC</i>	<i>after CTC</i>	<i>before CTC</i>	<i>after CTC</i>	<i>before CTC</i>	<i>after CTC</i>	<i>before CTC</i>	<i>after CTC</i>
Morwell City Council/ Homecare	13.75%	5%	after 10 years	after 15 years	na	na	na	na
City of Melbourne/ Aged service and waste management	11.6%	11.6 or 6%	13 weeks after 10 years	13 weeks after 10 years	4 weeks	4 weeks	15 days cumulative a year	15 days cumulative a year
Victorian Government/ Metbus services	14%	5%	after 10 years	after 15 years	5 weeks	4 weeks	15 days a year	8 days a year
June Private Prison	5% plus state contribution	5%	44 days after 10 years 99 days after 15 years	40 days after 10 years 70 days after 15 years	6 weeks (plus loading)	4 weeks (loading incorporated in salary)	15 days cumulative a year	8 days cumulative a year. 10 days after 1 year, maximum of 13 weeks

na not available.

Sources: ACTU (Sub. 75), Public Transport Union (Sub. 216), National Bus Company (Sub. 217) and information supplied by the City of Melbourne

B4.3.1 Factors influencing the impact on wages and conditions

There are several factors which may influence the extent to which CTC results in changes in the wages and conditions of employment:

- differences in award coverage; and
- increased use of part-time and casual labour.

Public sector and private sector awards

Differences in awards between the public and private sectors are likely to affect the wages and conditions of employees following CTC.

When examining the effect of differing awards, the AMWU stressed the importance of recognising the distinction between awards in the two sectors:

... the public sector is covered mainly by paid rates awards, prescribing actual rates and conditions, whilst the private sector is for the most part covered by minimum rates awards. However this latter form of award regulation is supplemented by over-award pay and conditions, negotiated on an employer by employer, and site by site, basis. (Sub. 299)

Thus, the actual pay and conditions of workers in the private sector are determined not only by awards, but also by any over-award conditions that may apply.

Serco Australia stated:

Private sector awards offer minimum rates that are typically lower than public sector awards, and then of course the competitive process forces us to move our wages towards, I guess, the minimum levels in those awards. So you will find that quite often in current circumstances in Australia that people will leave their public sector employment and join a company like Serco on a lower take-home wage. (Transcript, p. 1106)

Skilled Engineering observed that in both the public and private sectors:

For people moving to contractor employment Skilled's experience is that they are employed at standard award conditions and thus lose many of the additional benefits which may have been achieved over many years. These added benefits can be industry specific and tend to be an additional cost to the business. In many cases employers tended to regard such benefits as rorts which had been progressively forced upon the employers through industrial activity. (Sub. 69, p. 6)³

³ The AMWU noted that at least 77 per cent of all private sector employers make over-award payments to workers, and considered it misleading to describe such added benefits as rorts (Sub. 299).

Skilled Engineering also noted that employees' wages and conditions may be reduced following CTC as a result of being transferred to a different award, whether they are transferred from public to private sector awards, or between private sector awards.

The Community and Public Sector Union/Public Service Association of South Australia noted:

Remuneration savings on employees are possible due to lower rates for private industry industrial awards compared to those in the public sector. (Sub. 36, p. 3)

The Tasmanian Government considered:

... the public sector workforce can have difficulties competing in the traditional private sector market. The current industrial relations climate is one area where the public sector is placed at a competitive disadvantage in comparison with the private sector. Public sector terms and conditions are generally more onerous with unions sometimes requiring more restrictive work practices in the public sector than in the private, even under similar industrial awards. (Sub. 108, p. 34)

The Office of the Auditor General of Victoria gave as a major reason for the significant cost differential between the Metropolitan Transit Authority (MET) and private bus services:

The hourly rate of MET drivers is around 23 per cent higher than the rate paid to private bus drivers because of different industrial awards. (1990, p. 301)

Yet it is not always the case that public sector awards provide for higher wages and conditions. The Civil Contractors Federation stated:

... local government has a lower award wage system than the award under which private enterprise generally operates. This can lead to the situation where unions become disturbed when local government carries out work which may have been available to private enterprise. (Sub. 53, addendum 1, p. 5)

The Tasmanian Government also noted that "the trend towards enterprise agreements in the public sector is also leading to more flexible workplace arrangements that more closely reflect private sector conditions" (Sub. 108, p. 15). Indeed, as organisations and agencies move increasingly to enterprise bargaining, this may accentuate differences in wages and conditions of employment.

The Commission considers that, where wages and conditions of employment have changed, this may reflect discrepancies in public and private sector awards, or the normal practice in the particular service industry.

Part-time and casual labour

Shifts to greater use of casual rather than permanent employment, and part-time rather than full-time employment, associated with CTC can have significant effects on workers. The increased use of both casual and part-time employment enables organisations to better match variations in workload, thereby improving productivity and efficiency. For example, the Department of Defence (Sub. 81) suggested that contractors' use of casual and part-time staff for periods of peak workloads contributed to the lowering of costs. However each affects workers in different ways.

The shift from full-time to part-time employment can reduce the income of workers by reducing the number of hours of work. Hourly wage rates, security of tenure and entitlement to leave are not generally affected by a move to part-time employment.

The shift from permanent to casual employment has a different effect on workers. The ACTU noted that casualisation results in the deterioration of workers' terms and conditions through the loss of such entitlements as annual leave, sick leave and maternity leave. The ACTU supported the use of permanent part-time workers rather than casual workers as it preserves these conditions, while allowing workers — particularly women — to work shorter hours. The ACTU added that casualisation is undesirable because it results in an underpaid, under-trained and less committed workforce (Transcript, p. 1799).

A number of participants suggested that the introduction of CTC may increase the use of part-time employees to produce services (for example, Tasmanian Government (Sub. 108), Best Practice (Sub. 26), ACTU (Sub. 75), and Defence (Sub. 81)). Evidence gathered from industry visits also suggests that CTC leads to the greater use of casual labour. The ACTU also argued that evidence from the UK (Centre for Public Services 1995 and Ascher 1987) indicates that CTC results in casualisation of the workforce.

The increased use of part-time and casual workers following CTC may reflect a more general trend in the labour market. Part-time employment grew from 17.5 per cent of total employment in 1983 to almost 24.8 per cent in 1995 (ABS 1995a). Casual employment grew from 18.9 per cent of total employment in 1988 to 23.7 per cent in 1994 (ABS 1994d).

The tendency of contractors to use greater numbers of casual and part-time workers may reflect general labour market trends rather than being due to the use of CTC.

B4.4 Other employment impacts

B4.4.1 Career structures and development opportunities

Career development opportunities are often considered to be an important element of the working conditions available to employees.

Some participants suggested that contractors were able to offer better career paths and development opportunities than the public sector. For example, ISSC Australia suggested:

Career prospects and personal growth can be expanded for individuals moving from generalist employment to a specialised employer. For example, information technology staff employed in public service have learning and career opportunities enhanced in moving to a specialised information technology company. ... this has social and economic advantages in the most effective use of the nation's intellectual capital. (Sub. 88, p. 7)

Similarly, Skilled Engineering argued:

... whilst contracting out may reduce overall employment numbers, career path, skill enhancement and general experience of individuals can all improve under contractors specialising in that field of work and offering a variety of work experiences across broad geographical areas. (Sub. 69, p. 7)

However, the ACTU (Sub. 75) expressed concern that the significant progress which had been achieved in the public sector over recent years in terms of establishing career paths, improving training opportunities and introducing multi skilling would be adversely affected by the introduction of CTC.

The State School Teachers' Union of Western Australia argued that contracting out has reduced opportunities for career development in education:

The demise of the education research branch and the contracting out of policy and other documents has resulted in a narrowing of career choice for teachers in Government schools. In the past, teachers had opportunities to sidestep into other areas of the public education system for short periods of time allowing them to return to school revitalised. (Sub. 85, p. 2)

The Commission considers that, although CTC may result in changes to career structures, it may also lead to greater development opportunities for individuals through working for specialised employers and through exposure to different work environments.

B4.4.2 Job security

Some participants argued that CTC had adversely affected the job security of public sector employees. For example, the ECC (Sub. 90) argued that, while

cleaners previously employed by the NSW Government Cleaning Service have gained employment with the contractors, they no longer have the same degree of job security. The Tasmanian Government also stated that CTC had “generally an adverse effect upon morale due to a perception that job security and certainty had been removed” (Sub. 108, p. 15).

The ACTU submitted:

There is a great deal of evidence in Victorian Local Government during the present round of compulsory competitive tendering that CTC has destroyed worker morale and commitment with employees operating in a climate of fear. (Sub. 305, p. 18)

The Trades and Labor Council of Western Australia referred to the lack of job security resulting from CTC. It argued that the retendering of contracts every few years has an adverse impact on the job security for employees, whereas in the public sector there is no such threat. However, it accepted that job security in the public sector is no longer as great as it was (Transcript, p. 293).

And, at the Commonwealth level, the Public Service Commission stated that considerable reforms in the public service are “causing a shift in perceptions about the nature of employment in the APS. The Service can no longer be regarded as a certain career for life” (Sub. 74, p. 2).

Other participants argued – and the Commission agrees – that the best way to foster job security in the long run is to ensure that people have the skills to be competitive in the labour market. For example, Best Practice commented:

... the public sector is no longer “an employer of last resort” ... the best source of security for people is a guarantee not of a specific job or a specific employer, but of their employability. Employability security means offering people the chance to grow in skills and accomplishments so that their value to any employer is enhanced. (Kanter in Sub. 26, p. 15)

Similarly, Kempsey Shire Council argued:

... job security [is] based on being competitive with private enterprise, and to do that we need to have the same or better work practices and systems as private enterprise. (Sub. 178, p. 5)

To conclude, it seems to the Commission that protecting the employment of public sector employees by not engaging in CTC provides no long-term guarantees for their job security.

B4.5 Which employees are most affected?

The impact of CTC on different categories of public sector employees may differ. Some categories of workers are, likely to be displaced, but others will face greater employment opportunities. Similarly, some workers may face

reductions in wages and conditions, while the wages and conditions of others remain the same or increase.

This section considers the impact of CTC on:

- women and people from a non-English speaking background (NESB);
- people in low-skilled occupations; and
- older versus younger employees.

B4.5.1 Women and people from a non-English speaking background

Research in some other countries has indicated that women and people from a NESB are particularly vulnerable to reductions in employment as a result of CTC. Many participants were concerned that the same pattern is being replicated in Australia.

In the United States, Chandler and Feuille (1991) conducted a survey of 1541 public works directors in municipalities. They argued that the “displacement effect of CTC, especially among women and minorities who benefit significantly from public sector employment, has been the major reason for employee and union opposition to contracting out” (p. 16).

The UK Equal Opportunities Commission (1995) examined the gender impact of CCT and market testing on employment and pay in local authorities in England, Scotland and Wales. It suggested that women employees have been hit harder than men, with many women facing loss of jobs, reduction in hours of work and pay, an increase in temporary and casual work and a general worsening of their terms and conditions of employment. However, the study also found that in sports and leisure management (where males and females are employed in fairly equal proportions), female employment actually grew significantly, reflecting a shift from full-time male employment to part-time female employment. The disproportionate effect on women identified in this study appears to have been largely due to the concentration of women in the services of cleaning and catering.

As chapter A2 outlined, CTC in Australia covers a broader range of services than those five examined in the above study. This may limit the extent to which the conclusions can be generalised.

In Australia, there has been very little research examining the impact of CTC on particular employees. However, Fraser (1992) argued:

... while it seems plausible that the process would lead to similar outcomes in Australia, further research is required to verify whether or not this has been the case. (p. 12)

The ECC of NSW considered that female and NESB employees pay a high price when government services are contracted out to the private sector. It thought that the impact on people from a NESB is of particular concern because:

... their position in the labour market suggests that they may have more difficulty finding employment compared to people who have English as their first language. (Sub. 90, p. 8)

The ECC has been commissioned by the Bureau of Immigration and Population Research to investigate the effects of CTC on the female NESB employees of the NSW Government Cleaning Service. The results of the study are due to be released in 1996.

The Public Sector Research Centre also commented that CTC is likely to have had a particularly adverse impact on women employees:

Many of the services selected for contracting out and competitive tendering have been those in which women employees predominate. As an unintended consequence of the 'occupational segregation' that characterises labour markets, women employees are thus likely to have been disproportionately affected. Illustrations would be catering and hospitality functions, specified as activities to be covered by the first phase of CSP in the Department of Defence, and hotel and catering services in State hospitals. (Sub. 214, pp. 21-2)

Indeed, the composition of industries affected by CTC may have reflected the categories of employees who are most vulnerable to job losses. Where women and people from a NESB are dominant employees, they will be most at risk. As CTC becomes an increasing feature of other industries, the categories of employees most affected will also be likely to change.

However contracting in Australia is not only prevalent in services where women and people from a NESB are disproportionately represented. In addition to cleaning, IT and technical services are among the most contracted services (in terms of expenditure) across all government levels (see A2.3).

Some participants submitted that they have made special efforts to employ women or people from a NESB. The Australian Agency for International Development (Sub. 47) stated that its selection processes were expected to raise the participation of women in aid program delivery.

Some agencies employ people from minority groups to improve the delivery of their services to those groups. An examination of a sample of 100 curricula vitae of case managers contracted by ESRA indicated that two were from a NESB, and a further five were able to speak a language other than English. In total, seven individuals (just over 6 per cent) were able to communicate with people from a NESB. In addition, three case managers indicated that they were able to communicate with people with hearing disabilities.

Individuals disadvantaged in the labour market have access to general labour market programs. In *Working Nation* (Keating 1993) the Commonwealth Government made a commitment to strengthen the assistance available to those most disadvantaged in the labour market, namely, Aboriginals and Torres Strait Islanders, women, people from a NESB and people with disabilities. This will be achieved not only through the general restructuring and reform of labour market assistance but also through specific initiatives such as:

- improved migrant consultative arrangements, the continuation of the Workplace English Language and Literacy Program;
- increased eligibility for labour market assistance for women who are spouses of Job Search Allowance/New Start Allowance recipients; and
- greater publicity to increase women's awareness of the availability of labour market programs and services available after registering with the Commonwealth Employment Service.

The Commonwealth Department of Employment, Education and Training considered that the focus of its programs for the long-term unemployed has improved as a result of contracting out. It suggested:

The needs of these jobseekers as well as labour markets and employers are complex. Contracting out provides the flexibility to identify the most appropriate means of addressing these diverse needs in a cost effective manner. At the same time, the Department can assess innovative approaches that keep abreast of development in employment and training assistance and also can capitalise on emerging niche markets. (Sub. 230, p. 9)

B4.5.2 Workers in low-skilled occupations compared with managers

The changing nature of the functions performed by public sector agencies, away from direct service provision and towards contracting with external organisations, changes the nature of skills required for agencies to function effectively. Skills in the areas of contract specification, tender evaluation, the development of performance indicators, contract management and evaluation of contractor performance are all likely to be additional functions for government agencies where they have not engaged in CTC.

Employees, both in the public and private sector, who are skilled in these areas are all likely to have improved opportunities as government agencies seek to obtain the right mix of skills to effectively administer CTC (see chapter C8).

On the other hand, public sector employees engaged in direct service delivery are likely to face job losses as governments transfer functions to the private sector. In many cases, the services subject to CTC are likely to involve low-

skilled or blue-collar occupations. For example, contract cleaning and refuse collection are typically low-skilled occupations.

The South Australian Government noted:

One significant impact on employment is that it has been the routine, lower-skilled jobs which have disappeared. (Sub. 123, p. 29)

Albin (1992) conducted an econometric study of 58 councils across Australia, concluding that contracting out was advantageous for certain groups of employees. The results suggested that, although CTC did not reduce the labour force, the number of white collar employees increased at the expense of blue collar workers. A case study of Mosman City Council found that the proportion of blue-collar workers to white-collar workers was lower after CTC:

While engineers have done well from the introduction of competitive tendering in Mosman Municipal Council, the blue collar workers have not. ... The net result of competitive tendering on the Council's employees has been a reduction of at least eight blue collar workers, while the engineers had none of their ranks cut and had at least one more senior management position created for themselves. (Albin 1992, pp. 24-5)

Several authors have gone as far as to suggest that CTC is a deliberate attempt by senior managers in public sector agencies to improve the level of administrative control and protect their own positions (Dunleavy 1986 and Cawson and Saunders 1983). Dunleavy (1986) argued that CTC increases the size of executive and supervisory elements in an organisation. He suggested that this will increase overall costs as executive and white collar salaries tend to be higher than those of blue collar workers.

Rimmer (1993) claimed:

... in Australia there is no clear evidence that contracting leads to reduced wages, salaries and entitlements. On the contrary, in the late 1980s its use is likely to have resulted in increased remuneration for white collar employees. (p. 249)

DVA stated in relation to the outsourcing of the Repatriation General Hospitals:

... the lower classifications in domestic or clerical areas of the hospitals have worn the staff cuts. Similarly, it is the more specialised, higher paid groups who tend to be able to negotiate from a position of strength. (Sub. 110, p. 21)

As previously mentioned, the composition of industries affected by CTC is likely to reflect the categories of employees that are most vulnerable to job losses. Where employees in low-skilled and blue-collar occupations are dominant, they will be most at risk. However, CTC has also become a feature of services which are characterised by a fair degree of 'professionals' such as IT and policy advice. Consequently, as CTC becomes an increasing feature of other industries, the categories of employees most affected will also be likely to change.

B4.5.3 Older versus younger employees

CTC may affect old employees disproportionately. Older people are commonly disadvantaged in the labour force because of employer preferences for younger people.

In the UK, Ascher (1987) argued that there is “overwhelming evidence that contractors only select from the youngest and strongest applicants” (p. 106). However, she also suggested that CTC has benefited many older workers by enabling them to consider early retirement at enhanced pay levels.

Evidence on the impact of redundancies indicates that older workers are those most commonly affected. However very young workers are also likely to suffer long periods of unemployment following redundancy (ABS 1993).

The Commission concludes that reductions in public sector employment as a result of CTC are likely to affect some classes of employees more than others. To date, women, people from a NESB, low-skilled and blue-collar workers appear to have been disproportionately affected by CTC. However, these employees comprise a large proportion of those working in the service industries which have been tendered or contracted out to date.

To an extent, CTC is therefore exacerbating the difficulties that these particular employees have traditionally faced in the labour market. This highlights the importance of having effective labour market programs in place to assist them. The Commonwealth Government has sought to strengthen its labour market programs, which need to be flexible enough to reflect any change in the classes of employees most affected by CTC.

B4.6 Conclusion

The Commission has experienced difficulty in making judgments about the effects of CTC on employment and wages and conditions.

It is clear that the initial impact of CTC will be a significant reduction in public sector employment. However, over time, improved efficiency resulting from CTC is likely to lead to some increase in total employment. Examples of the impact of CTC on wages and conditions of employment also suggest that there will often be a reduction. Changes in wages and conditions are likely to reflect differences between public sector awards and agreements and those in the private sector. Some categories of employees may be more affected by these changes than others.

These effects highlight the need for effective labour market programs to assist displaced workers. Chapter C8 examines the importance of effective human

resource management in implementing CTC, including skills acquisition and handling excess staff.

B5 SOCIAL AND DISTRIBUTIONAL IMPACTS

B5.1 Introduction

In evaluating competitive tendering and contracting (CTC), it is important to take into account both economic efficiency and social and distributional impacts. The evidence assessed in chapter B3 suggests that CTC does generate net economic benefits to the community as a whole. The benefits are likely to be distributed among the major stakeholders in different ways. Some may stand to gain significantly from CTC, whilst other stakeholders may be disadvantaged.

In addition, governments have a number of social policies in the administration and delivery of their services to ensure equity and social justice. Of particular relevance in the CTC context are policies on access and equity (A&E) and equal employment opportunity (EEO).

This chapter examines these various matters, as well as occupational health and safety (OHS) and the environment.

The inquiry's terms of reference specify that the Commission have regard to the established economic, social, environmental, public administration and regulatory reform objectives of governments.

B5.2 The major stakeholders

The impact of CTC on the community, and major stakeholders, may vary within and between governments. The major stakeholders with an interest in CTC include:

- governments and their clients who are concerned about having fair and equitable access to services, particularly those from disadvantaged groups such as people with disabilities and people from a non-English speaking background (NESB);
- tax and ratepayers who are concerned about the effective and efficient use of their contributions whilst ensuring that a good range of quality services is provided;
- employees who may be concerned about their employment, wages and conditions; and
- external contractors who are interested in improving their profitability and market share through winning tenders for government services.

B5.3 The distributional impact of CTC

Participants indicated that CTC affects stakeholders in a number of different ways.

Redirecting savings into other higher priority areas

In some cases, the savings from CTC are directed to high priority government programs, through a variety of budgetary mechanisms. For example, at the Commonwealth level, savings generated by the Department of Defence's Commercial Support Program are distributed equally between the area where savings are made and priority activities in the rest of the department.

In New South Wales, the Premier's Department (Sub. 199) stated that allowing agencies to retain the savings for reallocation to high priority areas is an important factor in motivating agencies to explore opportunities for CTC.

Reducing taxes, rates and charges

The Commission has received evidence from a variety of sources on the issue of whether any gains from CTC are passed directly to tax and rate payers.

Albin (1992) used data from a sample of urban councils in Australia to test econometrically whether CTC resulted in outcomes which benefited taxpayers, either through lower taxes or a wider range of public services provided for a given level of taxes. The results suggested that, although CTC led to lower costs of providing services, taxpayers did not benefit from lower rate outcomes.

Rimmer (1993) also examined the impact of contracting on local government revenues in New South Wales and Victoria. His results suggested that the use of contracting did not have a significant impact on total rate revenues in New South Wales. This was also usually the case in Victoria though, where councils contracted five or six of the thirteen functions surveyed, contracting exerted a statistically significant and positive impact on rate revenues. He argued that the use of contracting in Victoria has not usually caused reductions in local government taxation revenues; cost savings may be used more generally to reduce debt, provide more and better services and/or increase management remuneration.

However, several participants indicated that savings generated by CTC may be used to reduce rates and taxes. The City of Melbourne (Sub. 89) stated that cost savings arising from internal reforms including the use of CTC have enabled it to pass on benefits to stakeholders. Overall rate revenue was reduced by 10 per cent in real terms, while Central City rates were reduced by 18 per cent.

The City of Ballarat (Victoria) indicated:

... the savings that are being achieved will progressively be redirected to ratepayers through either lessening of rates and charges payable or improvement in the delivery of services ... the government expectation is that savings should be continually redirected to ratepayers through reduced billings. (Sub. 314, p. 1)

In the City of Brisbane:

Any savings generated by contracting out would normally be retained within the Program in which the contract was managed so that either the level of services can be delivered at lower cost or an increased level of service delivered within the Program allocation. These savings in turn allow lower cost delivery of Programs to rate payers and generally lower total Budget outlays, allowing the Council to limit increases in rates and charges. (Sub. 318, p. 1)

Similarly, in the Shire of Swan (WA), where savings are generated by CTC they will be used in future to reduce rates.

Changing the quality of services received by clients

As to the effect of CTC on the quality of publicly-funded services, chapter B2 concluded that there is little consensus on the basis of available evidence from Australia and overseas. There have been examples of both improvements and reductions in quality following contracting. The impact on quality will depend heavily on how well the contract is specified, the contractor is selected and performance is monitored.

Changing employment and the wages and conditions of employees

CTC will also have distributional effects on public service employees. Some participants indicated that they had developed arrangements which allowed some of the gains to be distributed to employees through performance and productivity-based pay. For example, savings generated from the Department of Defence's efficiency initiatives, including under the Commercial Support Program, have enabled it to negotiate and fund productivity pay agreements whereby both Australian Defence Force and Australian public service (APS) personnel across the Department share the gains from productivity improvements (Sub. 81).

At the local government level, some of the savings generated in the City of Knox (Victoria) Construction Department have been shared with staff:

... when a surplus has been achieved on the tendered price, savings have been distributed on the basis of 33 per cent to staff and 67 per cent to Council. (Sub. 321, p. 1)

Other councils indicated that they were still finalising their position with regard to the distribution of some savings through productivity bonuses.

While some of the gains from CTC have been distributed to employees in some cases, the wages and conditions of public sector employees will often decline as a result of CTC, whether they remain in the public sector or are transferred to private sector contractors. However there are some examples of increases in wages and conditions under both scenarios. To some extent this may be indicative of general labour market trends such as casualisation, increasing part-time employment, changes in the demand for different skills and enterprise bargaining. Where employees are transferred to the private sector, it may also be due to differences between public and private sector awards or the normal practice in particular service industries (see chapter B4).

Where services are subject to CTC, chapter B4 concluded that there will generally be a reduction in public sector employment, whether external or in-house teams are successful. Where services are transferred to private sector contractors, there will also be an overall shift in employment from the public to the private sector. Some categories of workers are likely to be more affected by these shifts than others, for example, women, people from a NESB and workers in low-skilled occupations.

Some participants suggested that agencies should be required to undertake a 'social impact statement', taking into account a range of factors including the impacts of CTC on employees, as part of any assessment of the scope for CTC. This issue is addressed in section C3.2.1 of the report.

The limited evidence on the distributional impact of CTC suggests that tax and rate payers, employees and clients may be affected in a variety of ways.

B5.4 Government social policies

All organisations are subject to general legislation on anti-discrimination and affirmative action. This legislation reflects minimum acceptable community standards.

Governments (particularly the Commonwealth) have sought to implement these general requirements by developing public sector wide policies and practices. These are generally specific to the public service and include A&E, EEO and the Commonwealth Disability Strategy (see box B5.1).

Box B5.1: Public sector specific requirements**Access and equity**

Access and equity policies attempt to address the difficulties faced by women, people with disabilities, people from a NESB, and Aboriginal and Torres Strait Islanders. These groups have been identified as traditionally facing difficulties in achieving equitable access to services.

Access implies that all who are entitled to a government service should not face barriers. Equity implies that all who are entitled to government services should receive it equally, that is, without discrimination.

Equal employment opportunity

EEO policies are aimed at ensuring fair and equitable access to employment conditions and opportunities. There are four particular EEO target groups which have been identified as often not receiving equal treatment, namely women, Aboriginal and Torres Strait Islanders, people of a NESB, and people with physical and mental disabilities. EEO aims to improve opportunities for individuals from these groups to obtain employment and compete for promotion.

Commonwealth Disability Strategy

The Commonwealth Disability Strategy seeks to enhance access to the programs, services and infrastructure supplied by government to people with disabilities. It applies to the activities of Commonwealth departments and authorities and includes a requirement to produce Disability Action Plans.

Source: Office of Multicultural Affairs 1994

CTC may have an impact on the achievement of government social policy objectives in the delivery of government services. The Ethnic Communities Council of New South Wales (ECC) emphasised the importance of ensuring that government social objectives in service delivery are met:

If sufficient attention is not given to preventing the loss of social justice initiatives, then the process of contracting out can become a catalyst for future tensions, inequalities and discontentment – requiring much higher demands on the public purse in the longer term. (Sub. 90, p. 6)

Brisbane City Council commented:

While the major benefits arising from private sector participation in delivery of services are seen to be greater efficiency of resource allocation and a cost reduction through competition, there are costs. Social and environmental costs or goals, or non-commercial factors, cannot be ignored. (Sub. 121, p. 23)

A number of participants expressed concerns about the application of government social policy objectives under CTC, namely:

- whether contractors may avoid or ignore these objectives because of a focus on cost cutting to maximise profits; and
- the potential liability of government for the failure of contractors to fulfil their obligations.

B5.4.1 Access and equity

A commonly stated reason for government provision of services is to ensure that all members of the community have access to the range and standard of goods and services which may not be supplied by the market. Some participants expressed concerns about the impact on A&E for clients where CTC results in the movement from direct government provision to external provision.

The ACT Council of Social Service argued:

... contracting out important public services may result in a stratification of service delivery and quality as the commercial sector only deliver services to those who can afford to pay the price demanded, eg. disconnection of electricity to unemployed people. ... commercial sector providers may elect to terminate commercially unprofitable services, to the detriment of marginalised groups. (Sub. 79, p. 3)

The Combined Pensioners and Superannuants Association of NSW supported this view. Further, it considered:

... it is a prime responsibility of government to ensure that services for indigenous Australians, people from non-English backgrounds, including those who are deaf, people with a disability ... and women are guaranteed. (Sub. 116, p. 3)

The South Australian Council of Social Service (Sub. 58) stressed that a critical concern for the not-for-profit sector is that economic and narrower administrative goals may undermine the pursuit of social goals.

The ACTU (Sub. 75) shared this concern, suggesting that the private sector does not have the same values as government and as a result will be less likely to consider disadvantaged groups when providing services. It referred to the submission by the Aboriginal Community to the Joint Committee of Public Accounts Inquiry (1995a) into the Commercialisation of Public Sector Operations. In that submission, the Aboriginal Community argued that pressure to reduce costs as a result of CTC leads agencies and private companies to treat all clients in the same manner and does not allow for cultural differences and the particular problems of Aboriginal communities.

However, the Australian Law Reform Commission argued that the achievement of these objectives is equally difficult for government agencies as it is for contractors:

Aboriginals, people with disabilities, and those from non-English speaking backgrounds can be very detrimentally affected and taken advantage of if services are insensitivity delivered. But this is as true of direct as well as contracted out services. If a government body is fully conscious of the access and equity issues of special groups it, in my experience, is likely to choose and brief any contractor effectively and have monitoring in place to ensure performance is maintained. (Sub. 64, p. 3)

In this context, it is important to distinguish between contracting out and privatisation. One fundamental difference is that, under contracting out, the government retains the function of specifying what services are to be delivered, to whom and under what conditions. The government also retains the responsibility to ensure that the contractor actually fulfils its contractual obligations. The NSW Premier's Department also emphasised:

The type of service provider (in-house or other) is not necessarily the central factor in client satisfaction or in access or equity. Rather it is more likely to be a matter of the arrangements put in place to establish the requirements and standards and monitor performance. NSW Government policy is that quality, access and equity must be ensured regardless of who delivers the service. (Sub. 199, p. 10)

Some participants identified a number of innovative programs aimed at disadvantaged groups which have emerged as a result of CTC. For example, the Australian Chamber of Commerce and Industry (ACCI, Sub. 202) is involved in the Employment and Training Field Officers (ETFOs) Program aimed at gaining employment for the young and long-term unemployed. The program involves the contractual appointment of 56 ETFOs throughout Australia by the ACCI.

In the area of community health and welfare, services may be more appropriately provided by community-based welfare organisations. The Commission's recent report on *Charitable Organisations in Australia* (IC 1995d) acknowledged the valuable contribution of community social organisations in the delivery of services on behalf of government. It found that many mainstream community social welfare organisations were becoming increasingly aware of, and responsive to, the needs of people from ethnic communities and a NESB. For example, Meals-on-Wheels South Australia has undertaken to produce ethnic meals in South Australia and recruited volunteers from ethnic backgrounds to assist in meal preparation.

There are also examples of where contracting has improved service delivery and the achievement of social objectives. For example, the Employment Service Regulatory Authority stated:

The introduction of competition in this field, and in particular to "case management" of unemployed people, is intended to achieve a greater emphasis on the particular needs and circumstances of the individual job seeker and a greater focus on outcomes. It may prove to be an early and instructive example of how economic and social objectives can be combined to improve service delivery. (Sub. 139, p. 1)

Data collected on a sample of case managers indicated that there were a number from a NESB, with relevant language skills or with an ability to communicate with people with hearing disabilities. There were others who had previously provided services to the ‘mature unemployed’ as distinct from the young unemployed. The aim is to improve the employment outcome for a variety of people traditionally disadvantaged in the labour market.

The Commission notes that it is up to the government agency, not the commercial contractor, to specify the services to be provided and the terms and conditions of their delivery. A & E concerns should be addressed in this way.

Access to services may be inadvertently diminished if A&E requirements are not specified before CTC. The ACT Council of Social Service noted that some community service obligations (which include A & E) entailed in services are only implicitly defined. The Council argued that these commercial service obligations should be made explicit when CTC is being introduced (Transcript, p. 1207).

The Commission’s recommendation that agencies consult with stakeholders in the specification of the service should ensure that access to services is not diminished inadvertently (see recommendation C6.1).

Achieving A&E objectives under CTC

Achieving A&E objectives under CTC concerns community access to services, that is, the output produced by contractors. This could be achieved through two main approaches.

Incorporating them into contract specifications and contractor selection

The current practice of most government agencies undertaking contracting is to incorporate A&E objectives in contract specifications and/or contractor selection, where relevant. The South Australian Government explained:

Contract specifications stipulate the expected quality and standard of service. The Government is strongly committed to the principle of Service Quality and Standards, which will ensure future contracts address the needs of special groups such as people from non-English speaking backgrounds, access to disabled and senior citizens and any legislation relevant to the particular activity, including ... conformity to equal opportunity laws. (Sub. 123, p. 5)

The Victorian Government’s practice is similar:

... Departments can specify contract terms which explicitly recognise Government policies in relation to access and equity. Performance targets can then be established to ensure these policies are, albeit indirectly, adhered to by service contractors. (Sub. 215, p. 19)

As is the Tasmanian Government's approach:

In Tasmania the use of quality provisions in service agreements addresses access and equity issues. In fact the 'contract' on offer will have those issues central to its scope and purpose, including in the way the service outputs are defined. (Sub. 108, p. 14)

The Brotherhood of St Laurence supported this approach by governments:

Access to services for all those who require them should be a central component of the specification, service design and evaluative criteria for determination of successful tenderers. ... Accessibility and service appropriateness may relate to service location (and proximity to public transport), languages spoken and access to interpreters, cultural sensitivity, style of service delivery, hours of availability and conditions of eligibility for a service. Indeed, many factors (changing demographics, increased service demand, reduced program resources) can influence the accessibility of services over time. This necessitates ongoing program monitoring, sufficient flexibility in the contractual arrangements, and input to the planning process to respond to arising demands and changing circumstances. (Sub. 233, pp. 7-8)

One of the advantages of this approach is that it forces agencies to consider their social policy objectives and to develop formalised requirements and performance measures for the administration of the service. However, there is a danger that government agencies will incorporate overly prescriptive or process-oriented requirements into contracts. Wherever possible, contractual requirements should aim to be outcome rather than process-oriented. The Commission recognises that this may be both difficult and costly in some cases and prescriptive measures may be necessary (see chapter C6).

Monitoring and evaluating contractor performance ensures that social objectives are achieved in the performance of the contract. However, several participants emphasised the potential costs of doing so. For example, the Victorian Government noted that the costs might be so high as to negate the benefits of contracting out in some cases:

Whilst it is important for agencies to ensure the achievement of access and equity objectives, the costs of performance monitoring is an important factor in determining whether services delivered directly to the public should be contracted out. (Sub. 215, p. 20)

The ECC made the same point:

... with regard to Access and Equity and other social justice policies — all costs involved in ensuring such policies are understood by the contractors and are implemented and monitored, must be taken into account prior to the decision to contract out. If the costs involved in setting up the additional systems of monitoring, administration, complaints and regulatory mechanisms are fully considered, then it may be the case that it is more cost effective to maintain in-house service provision with existing programs, mechanisms and practices. (Sub. 90, p. 6)

The Commission acknowledges the point, but observes that government agencies are likely to incur some of the costs associated with A&E mentioned by the ECC (such as monitoring and a complaints mechanism) whether a service is provided in-house or by an external contractor. Where the costs of monitoring external contractors are greater than for in-house bidders, this should be weighed against the overall benefits from CTC (see chapter C3).

Applying public sector requirements to all government contractors

Another possible approach to achieving A&E requirements under CTC would be to impose existing public sector requirements on private sector suppliers to government.

The Commonwealth Human Rights and Equal Opportunity Commission recommended that action be taken to ensure that A&E is integrated into the CTC process:

Ensuring that the Commonwealth Access and Equity Strategy is strengthened, given stronger sanction and has its coverage extended to all services contracted out by government; and

Placing an obligation on contractors to produce Action Plans as part of their contractual access and equity requirements (as required of Commonwealth departments under the Commonwealth Disability Strategy). (Sub. 147, p. 3)

However, the ECC argued that many of the government policies such as A&E:

... largely fall within the domain of the public sector and are very difficult to implement within the privatised service. (Sub. 90, p. 4)

A&E requirements will vary between contracts depending on the type of service being developed. Therefore it appears more appropriate for an agency to ensure specifications remain consistent with broad government A&E requirements, and for particular requirements to be taken up in the specifications of contracts.

Access and equity objectives related to the output of the service can generally be incorporated in specifications of services to be delivered. This is preferable to an across-the-board extension of public sector specific requirements. Performance targets can then be established to ensure that these A&E requirements, reflected in the specifications, are achieved by service contractors.

B5.4.2 Equal employment opportunity and affirmative action

General legislation, such as Anti-discrimination and Affirmative Action, applying to public and private sector firms is aimed at preventing discrimination in employment. The *Affirmative Action (Equal Employment Opportunity for*

Women) Act 1986 requires that private sector employers of 100 or more people and higher education institutions lodge an annual report with the Affirmative Action Agency outlining their affirmative action programs. It is Commonwealth Government policy that any organisation which fails to comply with the Act is ineligible for government contracts and specified forms of industry assistance. A list of non-complying companies is updated quarterly by the Affirmative Action Agency.

Over and above the requirements of the Act, some governments have developed EEO policies and practices because of the difficulties faced by certain people in obtaining public sector employment. These public sector policies and practices are aimed at improving opportunities for women, people from a NESB, people with disabilities and Aboriginal and Torres Strait Islanders.

Some participants expressed concern whether EEO policies and practices would be applied by private sector providers. For example, the Public Sector Research Centre commented:

EEO issues have largely been excluded from the competitive tendering process, and existing policies are variably applied in Local Councils and rarely by the private contractors who win contracts. (Sub. 214, p. 23)

Achieving EEO objectives under CTC

Achieving EEO objectives under CTC concerns the use of inputs by contractors, that is, the employment and treatment of staff. It raises different problems from A&E. The problems arise whether EEO policies and practices are applied to all government contractors generally, or specifically through the specification of individual contracts.

The Australian Council of Social Service (Sub. 310) argued that public service EEO policies and practices should be transferred to contractors:

If public sector policies and practices are not extended to private contractors there may be a disproportionate impact on those who rely on access provisions to overcome the discrimination they experience in the workforce. (Sub. 310, p. 13)

Similarly it has been argued by some that public sector employment terms and conditions in general (of which EEO is a subset) should be applied to contractors working for government.¹

¹ The Australian Municipal, Administrative, Clerical and Services Union has lodged a claim with the Industrial Relations Commission, which, if successful, would prevent Victorian councils from contracting services unless the employees who are to perform the contract are paid and receive conditions in accordance with the Victorian Local Authorities Interim Award (1991) (Australian Municipal, Administrative, Clerical and Services Union 1995). The matter is scheduled to come before the Commission in March 1996.

The Victorian State Government argued that it is possible to incorporate EEO objectives in contracts:

Key objectives of Government can be articulated in contract specifications to achieve openness and accountability. Policies such as Equal Employment Opportunity ... can be included in contract specifications. (Sub. 215, p. 11)

This view was supported by other participants including the ECC (Sub. 90, p.6).

The Commission considers that there would be disadvantages in trying to apply to private contractors policies and practices which are particular to the operation of a level of government or an agency within a level of government. The policies may contain prescriptive or process-oriented performance requirements which may impose significant costs on business. It may also create distortions within private organisations supplying different markets, imposing administrative costs and potentially reducing the flexibility of contractors to move staff between tasks. (For example, a cleaning company providing services to the Commonwealth and state governments, the local council and private firms in a CBD could face different demands for the EEO standards to be applied within their workforce from each organisation). It will also create distortions both between private contractors supplying services to government and those supplying services to others. These costs will be reflected in contractors' bids, and in some cases may deter firms from bidding for contracts.

Where social objectives, like EEO, relate to the employment conditions of all those working on the contract, achieving these objectives by applying public sector policies and practices generally, or specifying them in contracts, can be costly.

B5.5 Occupational health and safety

Under state and Commonwealth OHS legislation a principal has a 'duty of care' not only towards his or her own employees but also towards the employees of its contractors. The legislation also places a 'duty of care' on the contractor, as the legal employer, for his or her employees. Generally the 'duty of care' requires the principal and the contractor each to take all reasonable and practicable steps to reduce those OHS risks that each controls or influences. Hence when a function is contracted out, the principal shares a legal liability with the contractor for the health and safety of the contractor's employees. The principal's liability varies with the extent of the control or influence that they can be reasonably expected to exercise.

Concern was expressed by some participants in relation to the obligations of contractors to ensure adequate OHS standards and the resulting liability of government agencies. The Shoalhaven City Council stated:

It is difficult to control contractors who elect not to renew their public risk insurance, or do not carry out proper traffic and OHS procedures. Councils can still be left with a hidden responsibility. Where Councils elect to hire equipment intermittently it is likely that the staff the contractor employs may not be adequately trained to work in public roadways where Councils have an implied duty of care. After the accident has occurred, the Council may be left with the responsibility because the contractor liquidates. (Sub. 205, p. 1)

Worksafe Australia argued that OHS difficulties should not be solved by contracting out work:

Managing risk by shifting health and safety problems to the private sector is not an acceptable way of dealing with them. Occupational health and safety risk should be managed by an accepted Hierarchy of Controls. (Sub. 51, p. 1)

OHS guidelines on purchasing were introduced by the NSW Government in March 1995. They require that tenders for major projects be accepted only from contractors who can guarantee that they have appropriate workplace health and safety systems in place. According to the NSW Premier's Department:

Contractors who disregard their statutory responsibilities, or who are ignorant of them, and do not comply with relevant conditions of contract in this regard, risk loss of the government's business as a sanction additional to sanctions in any relevant State or Federal legislation. (Sub. 199, p. 5)

The Local Government Association Mutual Liability Scheme (LGAML, Sub. 192) referred to the case in which a worker employed by Tempo Cleaning Services sustained an injury whilst performing contracted cleaning duties on premises of the Commonwealth of Australia. The LGAML suggested that the recent legal interpretation in the Tempo case, which held the Commonwealth liable, places an obligation on the principal to ensure the contractor's compliance with the provisions of the *Occupational Health, Safety and Welfare Act 1986* (SA) and the *Workers Rehabilitation and Compensation Act 1986* (SA). It concluded:

These circumstances create a significant exposure to liability for principals to contracts in South Australia, and particularly for councils entering into contracts as the owners and occupiers of a vast array of land and premises. There are also serious implications for their liability insurers. (Sub. 192, p. 15)

The Industry Commission has recently completed a wide ranging inquiry into Work, Health and Safety (IC 1995f), the report of which was released in November 1995. It recommended that government agencies, in awarding major contracts, consider requiring contractors to warrant that their safety management would fully comply with relevant OHS legislation. The Commission envisaged

that this may be achieved by requiring the relevant information to be submitted during pre-qualification of tenderers or in tender documentation.

B5.6 The environment

Several participants highlighted the importance of recognising the impact that contracting may have on the environment. For example, the Australian Council of Building Design Professionals expressed concern that:

... the selection of consultants, primarily on the basis of fees is prevalent within the public sector. This can result in reduced services and may lead to poor quality, inefficient buildings and infrastructure with high life time costs and poor environmental performance. (Sub. 130, p. 4)

Legislation exists to place environmental standards on all organisations. Best Practice argued that there is generally a greater obligation on private sector firms to comply with environmental regulations:

Private contractors cannot avoid, as government agencies often do, planning and building regulations, environmental and heritage protection, employee and industrial relations law expectations. Indeed market-forces — including customer and potential customer/community backlash — work to favour the private sector being more responsive to environmental, waste, privacy and other pressures than the public sector. In any case, it can be confidently assumed that contracting out will improve the community's capacity to ensure public sector financed services are provided in a manner consistent with contemporary environmental and ethical considerations. (Sub. 26, p. 13)

The Department of Defence (Sub. 81) argued that environmental considerations should be no different from other technical and quality matters specified in contractual arrangements. An example of this was provided by Skilled Engineering:

Skilled has been involved in submitting bids for the Sydney Water Board's extensive contracting out of its maintenance facilities work. The Key Performance Indicators associated with these tender documents are some of the best examples of driving contractor performance to comply with all necessary environmental requirements associated with Waste Water management embracing discharges to air, water and land. Contractor profits and management fee payments are tied to compliance with these environmental needs. Skilled's contract for maintenance services at Newport Gasfired Power Station in Melbourne Victoria also has performance standards associated with discharges to air and water. Again payments are tied to meeting these requirements. (Sub. 69, p. 4)

The Commission considers that existing environmental legislation should provide an adequate mechanism for ensuring that environmental concerns are addressed. Where there is a risk that contractors will fail to address

environmental concerns, agencies should seek to incorporate them into contracts or in the selection of contractors.

B5.7 Conclusion

A move from direct service provision to CTC is likely to have varying effects on different groups within the community. There are examples of where savings have been redirected into higher priority areas of government service, distributed through reduced rates, taxes and charges or incorporated into employee productivity bonuses and pay. CTC has also had effects on the quality of services, employment, and employee terms and conditions.

Governments at all levels often place great importance on the achievement of social and other objectives in the delivery of their services through policies relating to A&E, EEO, OHS and the environment. Where governments consider these objectives to be an important element of service delivery, they can usually be effectively incorporated into the CTC process either through the selection of contractors or the specification of contracts. However where social and equity objectives, like EEO, relate to the employment conditions of all those working on the contract, achieving these objectives by applying public sector policies and practices generally, or specifying them in contracts, can be costly.

B6 INDUSTRY AND REGIONAL DEVELOPMENT

B6.1 Introduction

Competitive tendering and contracting (CTC) has generally been used by governments to promote efficiency and more effective service delivery. However, CTC may have wider social and economic effects, including on industry and regions. This chapter examines those effects.

CTC can result in the creation and growth of markets traditionally supplied exclusively by public agencies, with significant flow-on effects for industries and regions. The South Australian Employers' Chamber of Commerce and Industry stated:

The main justifications for contracting out are cost savings, efficiencies and improved service delivery but the benefits can extend to economic benefits such as greater employment, investment and exports. (Sub. 104, p. 6)

CTC, and government purchasing more generally, is perceived to have and has had a significant impact on industries and regions including on:

- industry capabilities;
- industry competitiveness and export potential;
- industry structure; and
- the economies of rural and remote communities.

Moreover, being significant purchasers of goods and services, governments have recognised the potential benefits that CTC can provide to industry. Some governments have deliberately used their market power in an attempt to secure these potential benefits. The South Australian Government submitted:

Through the creative packaging of services, the Government attaches considerable importance to both the efficiency gains, to be shared by the community and the business sector alike, as well as the long term industry development potential. (Sub. 123, p. 2)

Councils in rural and remote areas raised concerns about potential adverse impacts of CTC on the local economy and social fabric. They were interested in possible options to minimise such impacts.

B6.2 The impact of CTC on industry and regions

In many instances it is difficult to separate the incidental impacts of CTC from those that result from deliberate policy action. This section examines the impacts regardless of origin.

B6.2.1 Increasing industry capabilities

A number of participants mentioned that action by governments to put service delivery increasingly to competitive tender has provided new market opportunities for private enterprise.

The variety of services has been growing, expanding from manual work such as refuse collection, building maintenance and road construction, to white-collar and social services such as information technology (IT), prison management, hospital services, employment assistance, policy advice, and home and community care (see chapter A2).

Access to these markets has given private contractors an opportunity to develop new capabilities and skills to meet the demands of government purchasers. The Commonwealth Department of Industry, Science and Technology argued:

From an industry development perspective, contracting out provides an opportunity for the private sector to develop industry capabilities by providing services to government that may previously have been provided from within government. (Sub. 156, p. 2)

And to give a few examples:

- the Civil Contractors Federation (CCF), South Australian branch, reported that firms in the bitumen industry have developed a number of innovative specialist products (eg Novachip, Fibredeck, Foam Bitumen) as a means of gaining an advantage over competitors when bidding for government contracts (Sub. 118);
- Defence's Commercial Support Program (CSP) has played a key role in encouraging the development of the electronics and communications sector in Australia (IC 1994b, p. 140); and
- the Ramsay Group has expanded its operations and become one of the largest private hospital operators in Australia after it bid successfully for two of the bed licences — Repatriation General Hospitals Hollywood and Greenslopes (Sub. 110, attachment 1, p. 33).

B6.2.2 Industry competitiveness and export potential

Increased industry capability resulting from a particular procurement can improve the competitiveness of the firm that wins the contract and the industry that it competes in. For example, the CCF, South Australian branch, stated that the expansion of government contracts on offer ensures “healthy competition in the marketplace”:

As more work becomes available, more tenderers are attracted to the work, competition keeps prices low; the capacity to carry out projects is not limited by the resources of just a few contractors. (Sub. 48, p. 5)

Moreover, a number of participants noted that access to government business could improve their prospects in export markets. Lend Lease Employer Systems submitted:

An increased presence in all levels of Government in Australia, with the associated increased economies of scale, would assist Lend Lease with its current expansion of services into both the private and public sectors in the South Asian region. (Sub. 133, p. 5)

Spark and Cannon considered that gaining access to the transcription business of government has provided firms with the opportunity to reach “the maturity and critical mass to contemplate the export of transcription services”. It stated that, as a result, Australian firms export their skills, technology and practices to markets such as Singapore, Hong Kong and the USA (Sub. 71, p. 7).

The Association of Australian Aerospace Industries stated that, in conjunction with the Department of Defence, it had invested considerable resources in building up the capability of the Australian aerospace industry. As a consequence of this improvement, repair and overhaul work is coming into Australia from other defence forces, resulting in the Australian aerospace industry achieving economies of scale and accessing work abroad (Sub. 137). Boral Asphalt also noted that the development of new or particular markets via CTC would give the opportunity to private contractors in road construction and maintenance to expand sufficiently so that they may export their product (Sub. 120).

Some participants argued that gaining access to government markets and being associated with supplying to the government gave private contractors credibility in overseas markets. For example, the Australian Agency for International Development (AusAID) stated:

After experience on AusAID projects many firms have been able to win contracts with the World Bank, the ADB [Asian Development Bank], the United Nations (UN) or other bilateral donors, including Japan.

... the aid program provides firms with opportunities to gain access to, and experience in, overseas markets. Involvement in aid activities helps firms to build an international reputation, to develop business contacts and to establish an 'export culture'. (Sub. 47, pp. 4 & 7)

The Australian Chamber of Commerce and Industry also acknowledged that government purchasing contracts can assist Australian firms to gain access to export markets. This may occur where providers of contracts in those markets feel comfortable offering contracts to Australian firms because they are 'sufficiently well regarded' by government (Sub. 202). The Commonwealth Department of Industry, Science and Technology supported this view:

... government procurement can ... provide official endorsement of suppliers, which can be important for winning business in overseas markets. (Sub. 156, p. 2)

B6.2.3 Industry structure

Another issue raised by participants was the effect of CTC on industry structure. For example, some considered that CTC programs give small and medium-sized enterprises (SMEs) an opportunity to expand their operations. The Department of Industry, Science and Technology stated:

Contracting out offers very significant opportunities to Small and Medium Sized Enterprises (SMEs), which are those companies most likely to adapt to technology and market changes, and to grow. ... As a general principle, a model that encourages value added participation by SMEs should be adopted. (Sub. 156, p. 2)

The Australian Information Industry Association endorsed this view and argued that access to government contracts for SMEs in the IT sector was important for their development:

Open access to government work remains a priority enabling small to medium enterprises an opportunity to establish reference sites, exports and, for the economy, a growth in employment within these companies. (Sub. 98, p. 4)

Other participants thought that the large size of government contracts induced multinational companies to bid and undertake long-term investment in Australia. They observed that multinational firms can bring with them new technology, knowledge and expertise that is passed on to Australian firms. For example, for the South Australian Government, one of the purposes of contracting out its metropolitan water and sewage treatment plants and main networks to a multinational company is:

... to connect South Australia to the prime contractor's own growth path in the Asia Pacific region and to transfer technology and skills to South Australian firms. This will enable them to be better equipped as potential resources to the prime contractor but also enhance their own independent export capabilities. (Sub. 123, p. 23)

However, some participants argued that government contracts were being won by a disproportionate number of multinational companies. They claimed that this has led to increased market concentration and therefore limited the opportunities for SMEs to develop. For example, the Public Sector Research Centre stated:

Across a range of services, including IT, and hotel and catering services, there is evidence in Australia of the increasingly successful operations of relatively small numbers of multinational corporations and/or their subsidiaries. This is consistent with international experience. (Sub. 128, p. 5)

... On the basis of who wins government contracts, the small business sector has not stood to gain an even proportionate share of the 'contract cake', which at the Federal Government level is worth \$30 billion each year to the private sector. (Sub. 214, p. 27)

ALLCO Finance Group also observed that, in the IT and telecommunication sectors, the bundling of financial commitments in contracts generally prohibits SMEs from making bids:

In our view, lack of financial strength represents the greatest handicap affecting the ability of non-multinationals to compete for major outsourcing contracts. (Sub. 177, p. 1)

Both ALLCO and the Public Sector Research Centre asserted that one of the major reasons SMEs were not winning their 'fair share' of government contracts is that the bundling of those contracts generally favours firms with large budgets. Chapter C4 discusses contract size and length and their implications for fair and effective competition.

Not all participants agreed that large firms were more likely to win contracts. The Small Business Development Corporation (WA) submitted that there have been a number of contracts let by Western Australian agencies which have provided different sized firms with opportunities to bid:

... the Water Authority of WA is administering a ten year Sewerage Infill Program, a large part of which is being contracted out in the form of small tenders to individual contractors and plumbing suppliers. Small firms have won a significant number of contracts in the last six months ...

The Building Management Authority of WA has instituted a competitive tendering policy for cleaning and maintenance services which allows small to medium sized firms, and self-employed people to tender for work.

Transperth has called for expressions of interest from small to medium sized firms interested in providing cleaning and maintenance services for its central Perth bus station, and other suburban facilities. (Sub. 103, p. 2)

The Commonwealth Department of Employment, Education and Training stated that SMEs may be more likely to win competitive tenders than larger firms:

Small business, with lower overheads and niche markets, may be more successful in winning outsourcing opportunities over the larger business. (Sub. 230, p. 17)

The City of Brisbane explained that a number of suppliers had competed for its service contracts, some of which were multinational companies while others were family businesses trading in the local area.

Some participants also noted that large contractors generally engage smaller firms by subcontracting or employing previous public employees. For example, Melbourne Water has contracted out to Serco, Theiss, Transfield and Siemens its civil maintenance and mechanical electricity work. Melbourne Water informed the Commission that these companies engaged 379 of its 880 employees affected by the contracts.

B6.2.4 Rural and remote areas

Councils in rural and remote areas are often large, if not dominant employers in the region, and generate considerable employment and income in supplier industries. Many of these councils told the Commission that the impetus they provide to growth also leads to less tangible benefits such as greater investor confidence in the region, better management of community resources and higher living standards.

Many councils in rural and remote areas were concerned that their ability to provide a stable economic and social environment would be dissipated with the introduction of CTC. For example, the Shire of Inglewood (Qld) stated:

It must be appreciated by other levels of government just how dependent small communities are on one or two major employers. This Council employs up to seventy (70) staff when completing a road contract job, with that staff drawn mainly from one town with a population of one thousand (1000). The impact of reducing the Council operations would be substantial. For example, if a major contract road construction job was lost to this Council, and performed by outside contractors, then competent staff would be retrenched from council and lost to the area as other employment opportunities simply do not exist. Likewise, Council would sell off surplus road plant and then be completely non-competitive for the future. Outside contractors would continue to do the work and take the much needed income away from our small community to the larger regional centres. (Sub. 10, p. 2)

Glen Innes Municipal Council (NSW) supported this view:

... there needs to be a balance between potential gain through contracting out ... with the reduced local government job opportunities in the community where council is a significant employer. (Sub. 180, p. 3)

Explicit opposition to compulsory competitive tendering by some rural and remote councils was based on concern about the possible implications for community development. The Shire of Burke (Qld) submitted that:

... there needs to be flexibility and an ability to recognise the need to provide a core of employment in the local community, whilst optimising the expertise and capacities that contractors can bring to the area. (Sub. 181, p. 2)

To this end, the Council carries out routine works by day labour as a means of boosting and stabilising the local economy, while contracting out its administrative support services, such as accounting, to take advantage of the expertise available outside of the region (Sub. 181).

A number of other rural and remote councils — including New England Local Government Council¹ (Subs. 211 and 258), Maclean (Sub. 186), Richmond River (Sub. 174), Guyra (Sub. 268) and Walcha (Subs. 161 and 249) from New South Wales; Emerald (Sub. 100) and Waggamba (Subs. 19 and 262) in Queensland; and Lucindale (Sub. 163), Penola (Sub. 127) and Yankalilla (Sub. 119) from South Australia — were concerned with a number of potential adverse impacts of CTC on local communities, including:

- loss of employment and income within the region;
- a transfer out of the region of local government capital and labour resources;
- the replacement of a public sector monopoly with a private sector monopoly, resulting in higher prices and lower quality of local services; and
- a reduction in the flexibility of the delivery of services, such as meeting emergency situations.

However, some participants thought that these problems should be, at least partly, manageable. For example, the Great Lakes Council (NSW) commented that councils could seek to maintain employment locally by requiring contractors to provide a local office or depot (Sub. 183).

The Local Government Association of Queensland (LGAQ) also noted that private contractors sometimes offer to take on employees from the region as part of their bid. However, the LGAQ considered that the problem for rural centres is that the private contractor will generally be based in a larger city. Even when it makes offers of employment to rural employees, this can result in a transfer of those employees to the larger city at the completion of the contract with adverse

¹ The members of the New England Local Government Council are: Armidale; Dumaresq; Glen Innes; Guyra; New England Tablelands County Council; Severn; Tenterfield; Uralla; Walcha; and Inverell.

effects on the local economy (Sub. 35). The LGAQ had no information on the extent of this impact.

The CCF supported the approach of private contractors employing local residents or bringing new residents to the region when winning local council contracts:

In the case of the work being awarded to private enterprise the new provider may well employ the existing employee or alternatively introduce new residents to the area. (Sub. 53, addendum 1, p. 2)

A number of the state branches of the CCF endorsed this point in their own submissions.

The Department of Defence submitted that contracting out may be used strategically to develop particular markets to support the Australian Defence Force (ADF):

The development of infrastructure in an Australian region enables the local market to provide strategically important forms of support for the ADF, eg repair and maintenance of ground vehicles. (Sub. 81, p. 12)

From the evidence provided to the Commission, it is not clear whether CTC will result in the decline of a rural or remote area's viability. As was found in chapter B3, CTC can and usually does reduce the ongoing costs of service provision. In most cases these savings are a result of reductions in labour costs (less employees, better work practices and sometimes lower wages and conditions). So there is the potential for an initial reduction in employment and income in a region as a result of CTC. These reductions may be greater if the contractor does not use local labour.

However, if councils subsequently spend the savings locally on improving the quality and lowering the prices of other services and/or return them to ratepayers in the form of lower rates, CTC has the potential to improve the employment and income of the region. Johnstone Council (Qld) stated:

The role of a local authority in encouraging and facilitating employment in the local economy cannot be disputed. This does not mean, however, that there needs to be direct employment at current levels. Increased economic activity in the local area through contracting out will facilitate more employment activity in the local private sector. (Sub. 17, p. 3)

The balance of effect therefore would seem to depend primarily on whether savings are spent locally and generate economic activity in the area (for example, by contractors using local labour).

Some councils in rural and remote areas have addressed the possible regional impacts of CTC by specifying contracts to ensure the employment

of local resources. Other councils have not favoured CTC, but have retained work in-house because of the potential adverse impacts on the local community.

By choosing to retain work in-house without CTC, councils may be forgoing the potential benefits from better use of local resources (that is, improving the quality and lowering the price of their services, and/or reducing rates). By competitively tendering work and using contract specifications to meet community development concerns, councils may be able to realise some of those benefits. This matter is discussed further in section B6.3.3.

B6.3 Using government purchasing to foster industry and regional development

Both Commonwealth and state governments are using purchasing activities, including CTC, to promote industry and regional development.

The Commonwealth Government has introduced two-envelope tendering, based on Industry Impact Statements, into its procurement policy.² This is designed to foster industry development opportunities for major acquisitions (over \$10 million in value).

State governments have been active in using their leverage to promote certain industries. The South Australian Government considers industry development a high priority area and has introduced a two-envelope approach for the competitive tendering of certain services. The Queensland Government has introduced a business and industry development program within its purchasing policy. Similarly, the Tasmanian Government submitted:

The Government also recognises that contracting out can be used as a component of economic development. Encouragement of firms, by providing them with opportunities to tender for Government business, can provide a base from which further business expansion can take place. In the absence of such tendering opportunities these firms may have insufficient work to enable their survival. (Sub. 108, p. 2)

Industry development programs may help facilitate industry development objectives by increasing industry capability, competitiveness and export potential. However, these programs also impose costs (see Bureau of Industry

² The Department of Defence is exempt from the requirements to develop Industry Impact Statements and use two-envelope tendering because 'it already has well developed and structured procedures in place to deal with industry development considerations in its tendering processes' (Sub. 140, Attachment C, p. 3).

Economics 1994b and Industry Commission 1995e). First, there are the direct costs of administering and complying with the programs. Second, government sponsored programs may result in firms diverting resources from more highly valued activities, thereby reducing the potential return that these resources can generate. The concern then is whether the benefits outweigh the costs to the community over time.

B6.3.1 Two-envelope tendering and industry impact statements

Under their new systems of two-envelope tendering, based on Industry Impact Statements, the Commonwealth and South Australian Governments both seek industry development commitments under specific contracts. In preparing Industry Impact Statements, government agencies are required to identify potential industry development opportunities which can be addressed by prospective bidders. Under two-envelope tendering, tenderers are required to submit two envelopes. The first envelope details how the firm's tender meets the product/service specifications (eg technical, financial and contractual requirements), along with the offer price. The other envelope contains the industry development proposal associated with the tender. The second envelope does not amend the offer price.

The Commonwealth's guidelines state that the assessment of bids will normally be based on the first envelope and that the government generally expects not to pay a premium for 'acceptable industry development outcomes'. In the 'rare instance' where an agency believes that a trade-off between value for money and industry development objectives is required, the agency should refer the decision to the Minister(s) (DAS, Sub. 140, attachment C).

Some participants argued that the second envelope did not normally generate any additional costs. The Commonwealth Department of Administrative Services (DAS) argued that both envelopes are subject to competitive markets and that it would not be in the interest of a firm to inflate the offer price to recover some or all of the costs of its industry development commitments. DAS considered that the government agency should therefore be able to estimate whether any firms have inflated the offer price from the different range of bids that it receives (Transcript, p. 1365).

The South Australian Government claimed that the winning tenderers for its recent IT and water contracts would have undertaken industry development activities in the absence of government compulsion and hence no premium was involved in obtaining industry development commitments. In its outsourcing of the whole of government's IT requirements, it claimed the industry development

commitments did not have an effect on the initial negotiations on the offer price by EDS (Transcript, p. 64) and stated:

There is therefore a synergy between what the South Australian Government requires of EDS and what they are proposing to do in the Asia-Pacific region. What the Government has succeeded in doing through its innovative outsourcing strategy is to have EDS undertake its activities in this State rather than elsewhere in the Asia-Pacific region. (Sub. 272, p. 4)

However, at the initial public hearings, both DAS and the South Australian Government agreed that, if a premium were involved, the absence of a price in each envelope does not allow it to be clearly identified. The South Australian Government stated:

So the Government through its Cabinet subcommittee made up its mind that it might have liked to have had more savings and maybe we could have got them if it didn't have the industry development initiatives on the end of it as well, but as to the exact premium, the process didn't allow us to specifically identify that. (Transcript, p. 59)

If a price is not sought for the commitments of the second envelope, bidders may adjust their first envelope to cover all or part of the costs associated with meeting their industry development commitments. ISSC Australia expressed concern with the transparency of the second envelope:

The industry development envelope in a two-envelope approach may not [be transparent] ... either if the hurdle set is of a general kind and no clear measurable connection to the assessment of the second envelope is in place and transparent. (Sub. 88, p. 6)

In its draft report, the Commission recommended that, where two-envelope tendering is adopted, a price should be stated separately in each envelope. This will assist a government to determine whether the industry development commitments of a firm will generate a net benefit — as the true costs associated with the programs are made clearer.

Both the New South Wales Premier's Department (Sub. 294, p. 2) and the South Australian Government (Transcript, p. 1865) were of the opinion that seeking a price in the second envelope would weaken the bargaining position of the purchaser by signalling a preparedness to pay for industry benefits. However, it is unclear why the same competitive pressures that apply in the pricing of the first envelope would not also ensure that any price in the second envelope only reflected the additional costs incurred.

Furthermore, the South Australian Government has now adopted what it considers to be a flexible approach to seeking pricing in each envelope, stating:

... we have specified the [separately priced] two-envelope system for the future ... the onus is on the agency, and the minister seeking to either modify that two-envelope

system or indeed move away from it, to be able to demonstrate to Cabinet that their process is such that the government can be confident that it is not paying a premium. (Transcript, p. 1864)

In its recent inquiry into *Computer Hardware, Software and Related Service Industries* (1995e), the Commission undertook a detailed analysis of the two-envelope tendering and Industry Impact Statement arrangements and identified a number of ways in which they may raise the cost of meeting industry development commitments. In particular, the report argued that these programs may:

- reduce the flexibility of the development of the industry by constraining the approach taken by tenderers to solve the needs of the customer. This is likely to result in a less efficient and dynamic industry;
- increase the complexity and uncertainty for contractors in preparing their bids. For example, bidders may err on the safe side and provide detailed documentation, or bidders may make industry development commitments that are over and above those required to satisfy the Industry Impact Statement;
- result in some contractors ending up with a succession of industry development commitments if they are participating in other industry development programs; and
- lengthen and complicate the procurement process. That is, additional steps and consultation may be required between the public agency and the bidder, both prior to tenders being sought and when bids are being evaluated.

The costs of meeting industry development obligations are likely to be higher where commitments are integrated into specific purchasing contracts. Such arrangements add to the cost and complexity of tendering, while affording firms the least flexibility in seeking internationally competitive activities. The greater the degree of flexibility that firms have in fulfilling their industry development obligations, the less likely that the pattern of development will be distorted away from activities that reflect their competitive advantage.

Recommendation B6.1

While government purchasing can bring some industry development benefits, leverage should be used with caution and not simply because governments have scope to do so. Its use should be restricted to circumstances where there are strong grounds for expecting net benefits to the community over time. Net benefits are most likely to occur where industry development obligations are not sought through specific contracts and firms are given as much flexibility as possible in choosing activities that fulfil their obligations.

Recommendation B6.2

When governments use two-envelope tendering in pursuit of industry development objectives, tenderers should be required to state a separate price in each envelope. When the contract is awarded, any additional costs due to industry development obligations should be announced.

B6.3.2 State government purchasing and CTC programs and practices

Prior to 1986, state and territory governments operated purchasing preference schemes that favoured producers in their own states when evaluating tenders for government contracts. These 'state preferences' contributed to a fragmented industry structure that potentially acted to reduce the competitiveness of Australian industries.

In 1986, the National Preference Agreement came into force with the consent of all states and territories. States and territories agreed to eliminate margins of preference which discriminated on the basis of state or territory of origin. Any margin of preference was to be applied only in favour of Australian content. It was up to each individual government to decide the rate at which this 'national preference margin' was applied. New Zealand joined the Agreement in 1989 and the margins of preference — where they still applied — were to be based on Australian/New Zealand content.³ The Agreement was renamed the

³ Currently, Queensland applies a margin of 20 per cent and Western Australia applies a margin of 10 per cent. New South Wales occasionally applies a margin of 20 per cent. Tasmania has not applied its rate (10 per cent) for several years. The Commonwealth,

Government Procurement Agreement (GPA) in 1991 following a review and an extension of its function.

The GPA encourages cooperation in reaching commonality in contractual, technical and performance standards and specifications amongst the Commonwealth, States, Territories and New Zealand. The Agreement also invites the parties, in conjunction with various other procurement authorities and industry, to examine specific measures and guidelines designed to achieve greater simplicity and uniformity in procurement policies, practices and procedures (Purchasing Australia 1991).

State agencies are also required to promote opportunities for Australian and New Zealand suppliers to compete for government contracts on the basis of value for money, and avoid offering contracts which favour foreign content goods and suppliers (Purchasing Australia 1991).

While the State and Territory Governments appear to adhere to the principles of the GPA in most of their purchasing decisions, certain activities (especially large-scale ones) may be treated differently. In some cases, these governments have established tender conditions that either favour local firms or create pressure for out-of-state firms to set up locally.

The South Australian Government, for example, has embarked upon two programs to attract industry by incorporating industry development obligations in the CTC process. The outsourcing of its total IT requirement was mentioned above. And it has adopted a 'Global partner' approach towards the management of Adelaide's water and sewerage services. In both cases, the work has been awarded to a large foreign company or consortium, which is required to set up in South Australia.

State and territory governments have offered a number of reasons why they may not always comply with the principles of the GPA. The most common reason is the desire to capture the wider economic and social benefits that CTC and general government purchasing can sometimes generate. For example, the South Australian Government submitted that industry development is a high priority area and that it is developing ways to locate and retain industry in the State through contracting out:

Through contracting out, opportunities are created to promote an expanded role for the South Australian private sector. The strategic use of contracting out in the delivery of government goods and services is therefore seen as one of the key initiatives to be pursued by all government agencies. (Sub. 123, p. 2)

New Zealand, Victoria, South Australia, the Northern Territory and the Australian Capital Territory do not apply a preference margin.

Similarly, the Northern Territory Government in its *Procurement Policy and Strategies* emphasises, amongst other objectives, the need for Government procurement practices to provide support to local firms and employment, and to encourage new firms to the Territory (Northern Territory of Australia 1994).

Further, public agencies in Tasmania commented at the public hearings that they do not have explicit preferential targets which they use in assessing bids. However, if they see any benefits for the State in supporting local industry, they would include these wider economic benefits in their decision making:

From the Hydro [Electric Commission point of view], we don't apply any preferences whatsoever but if there is a case to support local industry that would maintain its viability and help it grow further, then they may be considerations in the process. (Transcript, p. 1325)

... it's more of a strategic consideration [for Community and Health Services] rather than saying, "Okay, Tasmanian bidders get 20 per cent less". (Transcript, p. 1326)

The Tasmanian Government pointed to the local economic development potential of some activities resulting in contracts being bundled to favour local private contractors (as opposed to interstate or international firms). The Government concluded that "there is a feeling that, especially in the larger [regional] centres, more viable firms have been established in response to local contracting opportunities" (Sub. 108, p. 3).

The Commission appreciates that using CTC and general purchasing activities to encourage industry development may seem beneficial to the recipient state. But it may also distort industry structures and fragment both industries and firms at the state and national level, at considerable economic and social cost to Australia as a whole.

A detailed assessment of state-based procurement policies was undertaken in the Industry Commission's report on Computer Hardware, Software and Related Service Industries (1995e). The report concluded that state-based industry development policies may be at odds with, and put in jeopardy, the nationally agreed principles of the GPA, which all the State and Territory Governments have signed. The evidence presented to the Commission in this inquiry only reinforces that conclusion and serves to strengthen the accompanying recommendation, which is reproduced in box B6.1.

The Commonwealth Government's response to this recommendation was to note that the Standing Committee on Industry and Procurement, consisting of Commonwealth, State and Territory Departments, is examining better coordination on these issues with a view to reporting to Commonwealth, State and Territory Industry Ministers.

Box B6.1: Recommendation 2 of the Commission's Computer Hardware, Software and Related Service Industries Inquiry

The Commonwealth, State and Territory Governments should recommit to a national approach, along the lines of the Government Procurement Agreement, in the use of government purchasing for industry development. The Council of Australian Governments (COAG) should seek agreement on ways to avoid damage from industry development obligations and measures intended to attract activity to particular locations. In so doing, COAG should be mindful that:

- adequate information flows (between the Commonwealth and the states/territories) on opportunities for industry development are vital for the success of a national approach;
- procurement measures that discriminate against firms in other states/territories can threaten the viability of a national approach;
- the costs and benefits of industry development commitments and incentive packages should be calculated and made as transparent as possible;
- incentives offered to attract firms can impose costs within the state, in other states and for the nation; and
- costs arising from industry development and investment attraction policies should be borne by the jurisdiction concerned.

Source: Industry Commission 1995e

B6.3.3 Local government practices in rural and remote areas

In similar vein to Commonwealth, state and territory governments, local governments have adopted policies and practices aimed at promoting or protecting local industry and development. This includes deliberately retaining work in-house and incorporating regional development obligations in contracts. Such practices raise similar concerns as state-based industry development programs.

Many participants argued that any premium associated with using local resources to support a rural or remote economic and social base should not be of concern as the local community would be willing to pay more. For example, the Local Government Association of Tasmania argued that local governments have a 'vested interest' in ensuring that the economy of the region prospers as they are employers and consumers of local resources, goods and services. It added:

Against that background, councils should ask themselves whether there is a justification for paying slightly higher costs if it means supporting the local industry base, the community, and therefore reducing pressures on central government for 'welfare' payments. (Sub. 132, p. 13)

A number of other local government associations and councils also indicated that they would be prepared to support local businesses and organisations despite the potentially higher costs involved. For example, the LGAQ commented:

... each Local Government sees local economic development as a high priority. This may mean choosing to buy locally even if this is at an additional cost because the social and economic impacts of decline can be very significant. (Sub. 35, p. 5)

And the Shire of Inglewood (Qld) said:

Council supports a buy local campaign in an endeavour to bolster the local economy even though a premium price on some goods is paid. ... The effect of this is that council pays more for its operations and receives less revenue. (Sub. 10, p. 1)

Cabonne Council (NSW) supported this view:

However, in the wash-up should Council be obliged to compete with its staff for the provision of services and the costs of those services are at least equal to or slightly above those tendered by outside operators, it is most likely that Council would opt to maintain in-house services, infrastructure and resources, as it would consider this is the most beneficial service to its ratepayers and the best method of endeavouring to sustain the viability of the small towns and villages in its area. (Sub. 198, p. 3)

If a rural or remote community decides to give a preference to local suppliers (including in-house teams) or stresses the need for bidders from other areas to fulfil specific local obligations, the question arises: who should meet the costs of such practices? It seems to the Commission that the local community should bear the full additional costs itself.

Currently this may not be occurring. Local rates and charges make up 69 per cent of total revenue for local councils. They derive 25 per cent of their revenue in grants from the Commonwealth Government as general revenue sharing grants, as well as specific purpose grants from both state and Commonwealth sources (ABS 1995b).⁴ So taxpayers from outside the particular region may be funding local council support for the economic and social base of the region under CTC activities.

There is a further point. The local community needs to be clear about the cost of any preference to itself, such as higher rate payments and lower quality services. In this respect, while the Local Government and Shires Association of NSW considered that it is legitimate for local councils to use in-house teams to employ local council resources, it added that these resources should be used in the most cost-effective way and that any subsidy towards maintaining them

⁴ The remaining 6 per cent constitutes interest received and other revenue.

should be “identified as a separate component of the service delivery charge” (Sub. 54, pp. 2-3).

In addition, potential bidders from outside the community need to have confidence in the probity of the tender process. Otherwise they may see little value in bidding and then the CTC process will be ineffective. In this respect, the CCF commented that preferential provisions for the use of local resources have been misused in the past, generally to favour the in-house bidder. It considered, that where preference for local resources is adopted, it should be clearly specified and made applicable to all tenderers (Sub. 252, p. 2).

Recommendation B6.3

If local governments in rural or remote areas give preferences to local suppliers or require contractors to use local resources, that should be set down fully in the tender documentation; all tenders, including in-house bids, should identify separately the additional price for being required to use local resources; and when the contract is awarded, any additional cost due to a requirement to use local resources should be announced.

B6.4 Conclusion

Pursuing industry and regional development objectives may result in certain benefits. For instance, governments have helped to improve the competitiveness and growth opportunities — including an expansion in the scale of activities, an increase in the knowledge and skill base, an increase in innovation and the transfer of technology — for Australian industries and regions through offering an increasing amount of procurement contracts to competitive tender. These contracts have also provided firms with the experience and credentials in operating in government markets which may be an important factor in gaining access to overseas markets.

However the pursuit of industry and regional development objectives may also impose additional costs on purchasers, tenderers and the community generally.

COMPETITIVE TENDERING AND CONTRACTING BY PUBLIC SECTOR AGENCIES

Part C Improving the cost-effectiveness of CTC

- C1 Potential barriers to effective competitive tendering and contracting**
 - C2 The broad policy framework**
 - C3 Assessing the scope for CTC**
 - C4 Promoting fair and effective competition**
 - C5 In-house bids**
 - C6 The tender process**
 - C7 Quality assurance and performance monitoring**
 - C8 Human resource management**
 - C9 The way ahead**
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C1 POTENTIAL BARRIERS TO EFFECTIVE COMPETITIVE TENDERING AND CONTRACTING

C1.1 Introduction

Part B of this report examined the various effects of competitive tendering and contracting (CTC) of public services, so as to make some judgments about the costs and benefits of CTC.

The terms of reference also ask the Commission to identify ‘barriers to the cost-effective use of contracting out’. This chapter outlines possible barriers, in particular those identified by participants. The following chapters examine them in more detail, including how they may be overcome if they are unnecessarily restricting CTC. The barriers identified vary across jurisdictions and agencies, but affect all agencies to some extent.

As Couch & Associates noted, some of these barriers may also apply when efficiency improvements in the delivery of services are sought using methods other than CTC (Sub. 122). This emphasises the need to view CTC as one element in broader public sector reform.

C1.2 Public service and community attitudes

Many participants nominated the difficulty in effecting cultural change within the public service as a key impediment to successfully implementing CTC. The Tasmanian Government observed:

Political implications and the cultural attitude within the public service are the primary internal barriers to contracting out. These may mean that services with potential for contracting out are not given full consideration, or may result in less than optimal results when contracting out is progressed. (Sub. 108, p. 33)

A number of participants noted that agencies or individuals within them were often in a position to frustrate or prevent the adoption of cost-effective contracting out. For example, Boral Asphalt contended:

Barriers to contracting out are not necessarily legislative but rather are institutional or attitudinal. If agencies do not want to contract out then they will attempt to thwart the process The process of contracting out varies between agencies and levels of

government. In part it reflects political persuasions, local employment needs (rural areas), or local managers who do not want to lose an empire. (Sub. 120, p. 17)

One barrier identified by many participants is simply general resistance to change. As Ferrier Hodgson Corporate Advisory commented, one ‘can always find a reason not to do it’ (Sub. 167, p. 14). The Master Cleaners Guild of Western Australia submitted:

There has been considerable resistance of government agency management to even consider competitive tendering and contracting out as they appear to feel very threatened by it or are of the opinion it does not apply to them Further resistance has been created by the union and in some cases senior or middle management bringing pressure to bear on anyone interested in trying CTC ‘not to rock the boat’. (Sub. 80, p. 2)

The Australian Electrical and Electronic Manufacturers’ Association suggested that resistance to CTC may extend to several levels of an organisation:

While there is a commitment and understanding of the process of the CSP (Commercial Support Program in the Department of Defence) and its rationale at the central decision making level, this has not permeated to all levels of the ADF (Australian Defence Forces). There appears to be a general lack of commitment at the lower levels, extending to resistance in some areas, fuelled by the belief that defence support activities can best be retained by keeping them in-house. (Sub. 28, pp. 9-10)

Community attitudes were also seen as an important factor influencing the ability of agencies to undertake CTC. The Tasmanian Government commented:

Community expectations can also have a significant impact on the political decision to contract out. There are many services that the community expects to be provided by Government, provided free of charge or at subsidised rates, or to have access to a choice of public and private services. General examples include education, police services, public transport, courts, health and human services. Similarly there may be a perception that it is socially unacceptable to contract out. An anecdotal example is the contracting out of the New Zealand electoral roll. In this case there may be ethical and privacy issues hindering a move of the roll into the private sector. Therefore, despite the potential economic value of contracting out, the Government’s perception of community opinion, or of its community service obligations, may limit the scope of contracting out in certain examples. (Sub. 108, p. 33)

Chapter C8 discusses the issues associated with achieving changes in organisational culture.

C1.3 Industrial relations

A number of participants identified concerns of unions as a major impediment to the effective use of CTC as a public sector reform option. The Commonwealth Public Service Commission commented that the ‘union

movement is usually philosophically opposed to the transfer of functions from the public to the private sector' (Sub. 74, p. 5).

The Australian Law Reform Commission (ALRC) considered:

By far the greatest barrier — by a country mile — is the Australian industrial relations system which is predicated on the assumption that staff/workers have real (ie a pseudo proprietary interest) in the enterprise in which they work and not just a personal interest in fair and equitable remuneration etc for the job done while the department considers there is such a job to be done. (Sub. 64, p. 6)

The matter was also of concern to Johnstone City Council (Qld):

The single biggest impediment to governments competing with private contractors is the union based structures. The resultant inflexibility, restrictions and barriers to inefficiency that this creates needs to be addressed in the contracting out debate. (Sub. 17, p. 3)

Chapter C8 discusses the management of cultural change to CTC.

An example of an agreement which places restrictions on the use of contracting is the *Defence (Restructuring) Agreement 1994*. The Agreement was made after the introduction of the Commercial Support Program in Defence and provides that in-house bids must be allowed where the jobs of civilian Defence employees are involved. Chapter C5 discusses in-house bids.

To ensure that workplace bargaining does not restrict the use of CTC in NSW public sector agencies, the NSW Premier's Department stated:

... agencies are asked to ensure that Enterprise Agreements do not restrict the right of the employer to test the market and contract out during the currency of the agreement. (Sub. 199, p. 4)

C1.4 Accountability, caution and the lack of incentives in the public sector

Best Practice, a management consultancy company, considered that accountability requirements facing the public sector add to the costs of contracting:

Any contracting out business case must adequately take note of the costs involved in specifying, letting, managing and in evaluating the performance of the contract. Given the propensity of the public sector to err on the side of caution (and increasingly to worry about Ombudsman and other administrative law review bodies, let alone ICAC/Criminal Justice Commission intervention) these contract preparation and management reporting/control costs may be substantial — and dysfunctional to the desired end goal. (Sub. 26, p. 20)

One reason for public sector managers' caution and resistance to change may be the incentive system in which they operate. The NSW Premier's Department noted:

... one constraint is that the manager in the government organisation who best understands the issue may have something to lose if the activity is contracted out. Hence, a sound proposal from the private sector may have difficulty in finding someone to champion it. (Sub. 199, pp. 2-3)

The ALRC considered that in the public sector there is punishment for failure, but little reward for success:

Incentives for public officers to take risks are non-existent. Risks that succeed go unrewarded. The smallest failures are exploited publicly. (Sub. 64, p. 4)

The lack of incentives for public sector managers was seen by a number of participants as another barrier to the cost-effective use of CTC. As the Commonwealth Department of Administrative Services observed:

Extensive risk aversion, however, may result in significant cost penalties and diminished levels of efficiency to the detriment of program outcomes. (Sub. 140, p. 40)

The inability of agencies to retain savings from CTC was given as an example of how existing incentives discourage contracting as well as other methods of reform. The Department of Defence and NSW State Government agencies are able to reallocate savings from CTC to priority areas (Sub. 81, p. 16; NSW Government 1995).

Chapters C2 and C5 examine policies which affect public sector management incentives.

C1.5 Inadequate information systems

The measurement of input costs and outcomes is an issue for all public sector agencies, but the need for these intensifies when an agency considers CTC. Inadequately developed input measures make it difficult to compare existing costs with tender prices, and lack of performance measures, particularly for human services, may discourage the use of CTC.

On the issue of input measures, lack of knowledge of the full cost of services provided internally may be a barrier to CTC. If these costs are unknown, the incentive to use CTC or another method of reform may be reduced. The use of CTC in UK local government generated new information needs and demands for new accounting systems (Walsh and Davis 1993). Chapter C5 considers methods of costing public services.

Some participants saw the lack of information on well-defined performance measures for certain services as an impediment to contracting out those services. For example, the St Kilda Community Group believed:

... a major barrier to the effective tendering out of human services in particular is the lack of adequate, professionally acceptable performance measures for these services. We believe the rational way to proceed is to pilot particular services or parts of services, evaluate and modify. (Sub. 208, p. 1)

However, the Commonwealth Department of Human Services and Health noted:

Considerable work is in progress in this area, in many cases jointly with the States or providers. In some areas, we already have well developed outcome standards. Such measures are pre-requisites for any distancing of Governments (whether by contracting out or other means) from the provision of services. (Sub. 159, pp. 9-10)

Chapter C7 examines the use of performance measures.

C1.6 Lack of effective competition

Many governments, particularly those in less densely populated and rural areas, were concerned at the prospect of ‘capture’ by a contractor. For example, Kempsey Shire Council (NSW) compared the competitive environment in urban and rural areas:

City areas also have the benefit of attracting numerous tenderers from throughout the metropolitan area, creating greater competition and providing greater ongoing availability. This is usually not the case in country areas where in many instances there are very few local tenderers and the risk of one or two monopolising the field with inherent future price rises becomes a reality. (Sub. 178, p. 4)

Aged Care Australia (Sub. 189) suggested that the lack of aged care providers in rural and remote areas may be a problem in ensuring effective competition for this service.

Although Hobart City Council recognised this problem, it thought that there were sometimes ways of dealing with it:

In Tasmania, as with many rural areas throughout Australia, the lack of viable markets is a real concern. Yet again, those who raise this point seem to be equally unwilling to examine the question as to what mechanisms can be utilised to create a market by, for example, breaking work down into smaller components. (Sub. 153, p. 19)

Concerns have been also raised about ‘thin’ markets for particular activities, for example, when ‘sunk’ capital assets are involved.

Barriers to effective competition and ways of addressing them are considered in chapter C4.

C1.7 Lack of competitive neutrality

A number of participants identified the lack of fair competition between in-house and external bidders as a barrier to cost-effective CTC.

For example, several contractors stressed that many government bodies are exempt from government taxes and charges, such as sales and payroll tax. Therefore, when an external contractor competes against an in-house bid, the in-house bid faces a lower cost structure and an unfair advantage unless these taxes are taken into account in the tender evaluation process.

On the other hand, some governments identified restrictions on government agencies relative to private bidders. For example, the Brisbane City Council considered that the budgetary and borrowing restrictions faced by in-house bidders make them less competitive than private contractors (Sub. 121).

Factors affecting competitive neutrality are examined in chapters C4 and C5.

C1.8 Lack of skills

The NSW Premier's Department commented:

... a lack of skills in tendering processes, costing issues, contract administration and performance monitoring imposes high risks of failure. These issues are not adequately addressed by guidelines alone and need a range of measures including training, experience, networking, case studies and, where appropriate, the engagement or recruitment of people with the necessary expertise. (Sub. 199, pp. 15-16)

The Local Government Association of the Northern Territory (Sub. 213) supported the view that the provision of appropriate training programs for the development of contracting skills is essential.

Skilled Engineering (Sub. 69), Lend Lease Employer Systems (Sub. 133), and the South Australian Government (Sub. 123) were among those to suggest that agencies with no experience in contracting out work may lack the (often different) skills necessary to manage contracts effectively and efficiently.

In local government, the Hobart City Council considered:

Of the 800 or so Councils throughout Australia, a significant percentage do not currently have the skills and resources to undertake competitive tendering, or contracting out, to any significant degree. (Sub. 153, p. 4)

In addition to general contract management skills, the National Library of Australia commented that there was a general deficiency in the skills of public sector managers to initially assess whether or not CTC was the most cost-effective option for reform:

Agencies need to improve the skills of their staff in assessing the scope for contracting out and performance monitoring. To achieve this a culture needs to be established where contracting out should be considered routinely as an option for delivery of a wide range of services. The impediments to achieving this type of public sector culture include risk aversion, fear of competition, lack of awareness of commercial and business practices, and staffing issues resulting from contracting out decisions. (Sub. 25, p. 6)

Chapter C8 addresses the issue of skills in the public sector.

C1.9 Funding arrangements

Inter-governmental funding and financing arrangements were also seen as barriers to the cost-effective use of CTC.

C1.9.1 Cost-shifting

Some funding arrangements enable one government to transfer some of the costs of services to another level of government. This may distort decisions on contracting by increasing overall service costs.

In the health area, the Commonwealth Department of Human Services and Health noted:

... combined with State moves to competitive tendering this structure is, in effect, facilitating privatisation or corporatisation in various ways and shifting costs to the Commonwealth. This ... raises the question of the potential conflict between what might be cheapest for an individual hospital in the shorter term and what might be best for the Australian health system as a whole in the longer term. (Sub. 159, p. 6)

For example, public hospitals, which are the responsibility of State governments, are increasingly contracting out their pathology and radiology services, and are purchasing hospital bed days from private hospitals. When these and other services are contracted, some of the costs may be transferred to another level of government.

C1.9.2 Specific purpose payments

The Commonwealth Government's practice of providing 'tied grants' to state, territory and local governments may restrict the use of contracting in some cases.

Assistance is provided to not-for-profit, local government and approved for-profit providers of child care services to reduce the fees of eligible parents. In addition, under the *Child Care Act 1972*, local governments and not-for-profit

organisations, such as churches and community groups, are eligible to receive capital and operational subsidies for child care services. For-profit providers are not to receive these subsidies under the Act (City of Melbourne, Sub. 226).

According to the City of Melbourne, some services may no longer attract certain grants when they are contracted out:

Some government agencies, particularly those in the community and health service areas, ... have indicated that government grants will be terminated or placed at risk by proceeding with *contracting out*. Most continue to see local government as a provider, and not as a purchaser. Given the levels of such funding are very low, currently it is not a significant problem. However, it has the potential to be a significant concern, especially for other public sector agencies that rely on government funding. (Sub. 89, p. 22)

The Commonwealth Department of Human Services and Health indicated that its officers met with the City of Melbourne to discuss the implications of contracting out child care (Sub. 226). The Department has written to all local governments in Victoria advising them that capital funding and operational subsidies will not be available to for-profit providers who successfully tender for child care services (Sub. 320).

C1.10 Other legal and administrative impediments

Some participants considered that legal constraints presented a significant barrier to effective contracting out.

C1.10.1 Constitutional barriers

There are certain constitutional limits on the capacity of Commonwealth agencies to undertake business activities. The Joint Committee of Public Accounts in 1995 noted that business activities may only be undertaken by the Commonwealth where it has constitutional powers. These include where the Commonwealth deals with other Commonwealth agencies, in a Territory, overseas and interstate trade and with specified services such as defence, telecommunications and banking. The only exception to this is when there is 'spare capacity' not required at the time to fulfil core responsibilities (Joint Committee of Public Accounts 1995a).

This may have implications for Commonwealth agencies providing services to external organisations. For example, Auscript provides recording and transcription to courts and tribunals and bids for Commonwealth, state government and semi-government work. Where Auscript competes for non-Commonwealth clients, the Auditor-General expressed the view that these

activities may not be covered by the Commonwealth's powers under the Constitution (Auditor-General 1992a).

C1.10.2 Legislative impediments

The Victorian Government identified some non-local government Acts which prevent councils from delegating certain functions and powers to non-council staff (Sub. 215). The Tasmanian Government noted that similar restrictions operate in Tasmania:

Numerous pieces of State legislation include requirements for certain activities to be undertaken by a public sector organisation or an individual who is a public sector official. (Sub. 108, p. 33)

Serco noted that it could not fulfil all the requirements for managing the Puckapunyal army base because of a law in Victoria that permits dentists to be employed only by dental practitioners (Transcript, p. 1110).

C1.10.3 Tied arrangements

In the past, government agencies were often required to purchase services, such as car fleets or legal and printing services, from a single government supplier.

Agencies have been or are being freed from some of these restrictions and allowed to purchase services from the private sector if they wish. A recent example was the Commonwealth Attorney-General's Department losing its role as sole supplier of certain legal services to other Commonwealth Government agencies. At the state level, the Victorian Government has removed all tied arrangements, most recently that requiring legislation to be printed by the Law Printer.

However, some tied arrangements still apply at the Commonwealth and state government levels. For example, Commonwealth agencies must purchase fleet services from DASFLEET. In Queensland, building surveys are still tied.

C1.10.4 Specification of employment relationships

Agency Contracting Services (ACS) was concerned that tenders are often written in a way that assumes an employer-employee relationship. As ACS uses independent contractors rather than employees, it can be prevented from bidding:

Tendering and Expression of Interest documents used by the public sector for contracting purposes generally have as a requirement the maintenance of an employer-

employee relationship by the submitting bidders. Organisations ... supplying independent contractors outside the employer-employee relationship are consequently unable to submit conforming bids. (Sub. 281, p. 2)

C1.11 Conclusion

In examining the successes and the failures of CTC, some factors emerge as potential barriers to its cost-effective use. These include lack of competitive markets, lack of incentives in public sector management systems, inter-governmental funding arrangements, legal restrictions and lack of skills.

The following chapters in Part C examine these barriers in more detail and whether there are ways of addressing them so as to improve the cost-effectiveness of CTC. In broad terms, they may require either action at government and inter-governmental level, or strategic approaches at agency management level, or attention 'at the coal-face'. Some of the barriers are already being addressed by governments and their agencies.

C2 THE BROAD POLICY FRAMEWORK

C2.1 Introduction

Competitive tendering and contracting (CTC) is only one of many initiatives taken in recent years by governments in Australia and other countries to improve the delivery of government services. These include services used by government itself, such as corporate services, and those provided to the community, such as garbage removal and health and welfare services.

The challenge is to establish a policy framework in which this management tool, CTC, can be used to help achieve government policy objectives. This includes removing unnecessary biases which may distort the decision to use one management approach over another.

The previous chapter outlined a number of potential barriers to the cost-effective use of CTC. This chapter first examines those broad government policies and arrangements which need to be addressed at a 'whole of government' level. It then examines specific government policies on CTC, including the use of government-wide guidelines on CTC and compulsory competitive tendering.

C2.2 Broad policies affecting CTC

The broad policies, which are not determined by individual agencies but affect the cost of CTC, include inter-governmental funding, public sector management and budgetary systems, and other regulatory and legal barriers.

C2.2.1 Inter-governmental financial arrangements

The previous chapter mentioned several areas where inter-governmental funding arrangements may be inhibiting the cost-effective use of CTC, either by restricting or unintentionally encouraging its use. These include:

- **Cost-shifting:** The problem arises when decisions to use CTC may be motivated by the prospect of shifting costs onto another level of government rather than improving service delivery. For example, several participants argued that cost-shifting occurs when public hospitals subject pathology services to CTC

- **Specific purpose payments:** Some funding arrangements impose conditions on the ways in which programs may be delivered — such as agreements under which the Commonwealth Government provides grants to State, Territory and local governments. For example, conditions under the *Child Care Act 1972* restrict some types of funding when for-profit contractors are engaged.

These points raise questions which extend beyond the scope of this inquiry and which may require resolution at an inter-governmental level. Indeed, some of them have started to be addressed. Although some regulatory restrictions on funding of for-profit contractors remain, funding has recently been extended to include them in the case of eligibility for disability programs (Department of Human Services and Health, Sub. 226).

The Commission is not suggesting that policy reform in these areas should be driven by their effects on decisions of whether or not to use CTC. However, the potential benefits available through CTC should not be unintentionally forgone. Any review of these arrangements should include an assessment of whether they unnecessarily undermine the use of CTC, while ensuring that the objectives of the arrangements are achieved.

C2.2.2 Other legal and administrative barriers

The previous chapter gave examples where participants identified legislation restricting the use of CTC. There are also administrative barriers to the use of CTC, including requirements that Commonwealth and State agencies purchase from government suppliers.

To some extent, these matters are already being addressed. In the case of legislative restrictions on contracting in local government in Victoria, the Office of Local Government is reviewing regulations which mainly deal with the functions exercised by councils (Victorian Government, Sub. 215). In some governments, services such as printing and building maintenance have been gradually untied from sole government suppliers, allowing agencies to obtain these services from the private sector if they wish.

Also, all anti-competitive Commonwealth and State legislation will be reviewed, under the Legislation Review Principles set out in the Council of Australian Governments' (COAG) *Competition Principles Agreement*. Legislation which restricts competition, or imposes costs or benefits on business, will be reviewed by the year 2000. Such reviews will be transparent, independent and accessible to all interested individuals and groups. They will identify the objectives of and necessity for regulation, alternative approaches to

achieve such objectives, the costs and benefits of each alternative and choice of the best type of regulation.

However, some legislative or administrative barriers to the use of CTC will become evident when potential benefits from CTC have been identified, or tenderers propose new ways of providing particular services. The restriction on who can employ dentists is one example (see section C1.10).

While there is a nationally agreed framework for the review of regulatory barriers to CTC, governments should examine particular restrictions as they are identified. When they do so, the reasons for the restrictions, and whether the objectives of the regulations can be met in ways which do not restrict the use of CTC, should be assessed.

C2.2.3 Public sector management incentives

Several participants were concerned that a major barrier to improving the cost-effectiveness of CTC (and public services generally) is that there are few incentives for public sector managers to do so. In particular, participants were concerned that the limited range of rewards for risk taking and penalties for failure discouraged public sector reform.

When all savings obtained from efficiency improvements have to be returned to consolidated revenue, public sector managers may have little incentive to pursue efficiency gains through reform, including the use of CTC. In this context, the Commission notes that, in some jurisdictions agencies are permitted to retain all or part of the savings from efficiency gains. For example, both the Department of Defence and NSW State Government agencies are able to reallocate savings from CTC to priority areas.

A broad range of public sector financial management reforms are currently under way at all levels of government in Australia. Some have addressed the risk and incentive issues raised above.

These initiatives will improve the cost-effectiveness of CTC.

C2.3 CTC-specific policies

All Australian governments have general purchasing policies and guidelines which affect the conduct of CTC to some extent. Some governments have developed separate policies on CTC which reflect the greater emphasis they place on CTC as a means of increasing the effectiveness and efficiency of service provision. These policies include CTC-specific guidelines, mandatory

use of CTC, whether in-house bids are allowed and the establishment of specialist units to monitor or help agencies implement CTC.

Table C2.1 outlines the main features of Commonwealth, State and Territory government CTC policies, which are described in more detail in appendix B. Local government policies are not summarised in the table, but are covered in appendix B.

C2.3.1 Government guidelines

Some governments and agencies which undertake a large amount of competitive tendering have supplemented their general purchasing policies with CTC-specific guidelines:

- at the Commonwealth level, there are no government-wide CTC guidelines, but agencies such as the Department of Defence and AusAID have developed detailed manuals or procedures to implement CTC;
- the NSW, Victorian, Western Australian and South Australian State Governments have CTC guidelines to be used by all their agencies. The Queensland, Tasmanian and ACT Governments are developing them. The guidelines tend to offer general rather than detailed assistance to managers to help them implement CTC; and
- at the local government level, the Institute of Municipal Management has distributed a *Compulsory Competitive Tendering (CCT) Procedures Manual* to help local governments in Victoria. The City of Melbourne published its *Competitive Tendering Guidelines* in August 1994. The Victorian Department of Health and Community Services (1994) published a guide for local governments when councils competitively tender programs funded by the Department of Health and Community Services.

The purpose of these guidelines and manuals is to encourage the consideration of CTC by government agencies and to assist staff conduct competitive tendering. The Commission was told by practitioners at all levels of government that they refer to them often. As to whether they find them useful, the Tasmanian Government considered that several existing state government guidelines were not practical enough:

Table C2.1: Summary of Commonwealth, State and Territory Government CTC policies

<i>Main features</i>	<i>Commonwealth</i>	<i>NSW</i>	<i>Vic</i>	<i>Qld</i>	<i>WA</i>	<i>SA</i>	<i>Tas</i>	<i>ACT</i>	<i>NT</i>
Are there CTC-specific guidelines?	No	Yes	Yes	Policy under consideration	Yes	Yes	Being developed	Being developed	No
Is there compulsory competitive tendering?	No, only in some cases	No	Only for local government	Policy under consideration	No	No	No	No	No
Are in-house bids allowed?	Yes	Yes	Not encouraged	Policy under consideration	Yes, in some cases	Yes	Not encouraged	Policy under consideration	No
Is industry development an evaluation criterion?	Yes, for large & IT purchases	Sometimes	Sometimes	Policy under consideration	Yes	Yes, for large purchases	Sometimes	Policy under consideration	Sometimes
Can the agency retain savings?	Yes, in some cases	For priority programs	No	Policy under consideration	Yes	Yes, if agreed by Cabinet	To be resolved	Policy under consideration	No
Are costing guidelines available?	Yes	Yes	No	No	Yes	Being developed	No	No	No
May the public sector compete in the private sector?	Yes	Not usually	No	Policy under consideration	No	No	No	Yes	No
Are detailed CTC manuals available?	For Defence & AusAID	No	Yes	No	Yes	No	No	Being developed	No

Source: See appendix B.

Extensive guidelines that outline broad policy objectives and practical assistance are important to assist managers in the implementation process. ... The only impressions gained about the New South Wales and Victorian guidelines are that while they will provide a policy framework for Agencies, they lack detail and practical assistance. (Sub. 108, p. 35)

The Victorian Department of Treasury and Finance is developing a more detailed set of guidelines to enhance its earlier version. It will include a standard framework to evaluate outsourcing (Sub. 215).

Several contractors argued that whole-of-government guidelines reduced the costs and uncertainty of bidding. Serco Australia suggested that contractors would be more prepared to bid for contracts with agencies which have specified the tendering process:

The customers we focus on are those who take the trouble to develop a manual that sets out the process. ... I don't think we have come across anybody that had done it as thoroughly as Defence. I mean the various State governments are putting out manuals. They tend to be fairly brief documents. ... Similarly the Ministry of Defence in the UK has done it, but they're very brief compared with Defence methodology. (Transcript, pp. 1107-8)

The Civil Contractors Federation strongly supported the more detailed approach and favoured common guidelines to apply to all levels of government:

... there is a fundamental need for some sensible practical guidelines to manage the process of contracting out and we would refer the Commission to the Victorian [local government] guidelines in particular. (Transcript, p. 1146)

... there needs to be wherever possible consistency in guidelines. It may well be appropriate that the best guidelines need to be identified and adapted universally. (Sub. 252, p. 2)

The Department of Administrative Services considered that centrally developed guidelines would reduce the costs of smaller agencies implementing CTC:

... the cost of implementing CTC would be reduced if guidelines were developed centrally thereby helping smaller agencies with limited resources and limited experience of CTC. Central development of guidance material would also promote consistency of approach across jurisdictions. (Sub. 300, pp. 1-2)

A benefit of CTC-specific guidelines is that they indicate that the government wants CTC to be considered routinely as an option by managers. CTC presents some challenges that are less prevalent in the purchase of goods, including:

- difficulties in defining the service to be contracted;
- a more continuous relationship between purchaser and provider; and
- management of in-house bids.

However, centrally developed CTC guidelines should not be so prescriptive as not to allow sufficient flexibility at the agency level, because factors such as service and market characteristics may vary considerably.

Recommendation C2.1

Those governments which do not have specific CTC guidelines should develop them as a matter of priority. They could usefully draw on guidelines which have already been issued by several State governments. The guidelines should be sufficiently detailed to be of practical use, but flexible enough to take account of the different types of service, market characteristics and agency circumstances.

C2.3.2 Compulsory competitive tendering

Background

One method governments have used to promote the use of CTC is the imposition of mandatory targets on agencies to competitively tender either specific services or shares of total expenditure.

In Australia, the most notable example of compulsory competitive tendering is in local government in Victoria. The Victorian *Local Government Act* was amended in 1994 and required councils to put to tender a minimum of 20 per cent of total expenditure in 1994-95. The minimum increases to 30 per cent by 1995-96 and 50 per cent by 1996-97.

The ACT Government saw a possible role for compulsory competitive tendering:

While the ACT Government can see that there is a role for compulsory competitive tendering such an approach needs to be carefully considered. The Government's initial view is that it is unlikely that the ACT will need to adopt a compulsory approach at this stage. (Sub. 266, p. 8)

The Commonwealth Government has imposed competitive tendering in certain areas. The first stage (Tier 1) of the Department of Defence's Commercial Support Program in 1991 involved compulsory competitive tendering for 28 activities performed by the Australian Defence Force.

The *Australian Land Transport Development Act* 1988 requires all new construction and most road maintenance funded from Commonwealth road

grants to the States and Territories to be competitively tendered. Government agencies may bid. Also, the Commonwealth National Transmission Agency was required to tender 50 per cent of the value of the capital projects it initiated in 1994-95 (Sub. 191).

The Local Government and Shires Associations of NSW, which opposes compulsion, noted that early drafts of the Local Government Bill 1993 provided for tenders to be called for 'significant public works or services'. The 1993 Act did not require these works to be tendered (Sub. 54, pp. 1-2).

In the UK, legislation makes competitive tendering compulsory for local government expenditure on refuse collection, catering for schools and social services, cleaning, sport and leisure management, and vehicle maintenance.

Compulsory competitive tendering should not be confused with compulsory contracting out. Where competitive tendering has been compulsory, in-house teams have always been allowed to bid. No examples of **compulsory contracting out** have been identified by the Commission, although the Western Australian Premier's 1994 Circular to Ministers may approach this (see appendix B).

Reasons for compulsion

The main reason for the introduction of compulsory competitive tendering has been to obtain better value for money for government services by exposing internal providers to competition with other providers. In this regard, the Victorian Minister for Local Government stated that amendments to the *Local Government Act* were designed:

... to introduce competition to require councils to look hard at their own operations and improve efficiency. ... This bill heralds a cultural change which goes to the very core of the way councils operate. Councils will be compelled to review and specify just what it is they do, and to test those specifications in the marketplace. If in-house staff fail to measure up to the competition, those who can provide better service should take over ... Ratepayers are entitled to expect value-for-money from council services. (Victorian Hansard 19/4/94, p. 140)

The requirement to tender in the *Australian Land Transport Development Act* 1988 was aimed at obtaining best value for money spent on roads (Hansard 9/11/88).

In the UK, the aim of the local government legislation requiring competitive tendering was to introduce competition and market processes into local government (Walsh 1991a). It was also suggested that compulsion was introduced because reform would not have happened otherwise. An advocate of compulsion in the UK considered:

... the Government found itself, after years of exhortation, driven to compulsion in despair at the failure of Conservative as much as socialist councils to go out to tender voluntarily (Carnaghan & Bracewell-Milnes 1993, p. 37).

It is interesting to note that, in the UK central government and the Victorian State Government, compulsory competitive tendering has not been imposed on their own agencies over which they have direct management control, but it has been imposed in local government over which they have less direct control.

This suggests that in some cases compulsory competitive tendering is used when other incentives to achieve reform have proved to be ineffective and the potential gains from reform are judged to be large. For example, governments are able to impose budgetary constraints on, and allow savings to be retained by, their own agencies. This is difficult to impose on other levels of government, such as local government, which is also able to raise its own revenue.

The effects of compulsion

In Victoria, the Minister for Local Government reported to Parliament in November 1995 on the first year of the implementation of compulsory competitive tendering in local government. The first year target of subjecting 20 per cent of total expenditure to CTC was achieved by seventy-three of the seventy-eight councils. Three councils tendered more than 40 per cent of their total expenses. The Minister accepted the five councils' reasons for non-achievement of the 20 per cent target. Non-metropolitan councils tendered slightly higher levels of expenditure than other councils, possibly because rural councils traditionally tender for physical works and services (Victorian Office of Local Government 1995, pp. 10-11).

A four-year research program monitoring the impact of compulsory competitive tendering is being undertaken by the Outer Urban Research and Policy Unit at the Victorian University of Technology. The focus is on the effects on human services in ten local governments in Victoria. An initial scan of the first stage of the research found:

Despite differences in attitude, all case study councils were at one in the view that CCT (compulsory competitive tendering) is an irresistible and ground-shaking force, and that its impact will well-and-truly supersede the residual effect of amalgamation. But there were differences as to whether CCT represents a means (along with other processes) for local government workplace reform, or an end in its own right. (Ernst and Glanville 1995, p. 5)

A recent survey¹ in Victoria indicated that almost two-thirds of people surveyed supported councils competitively tendering services, with most considering that

¹ The survey randomly interviewed 250 households in Victoria by telephone.

tendering would improve services and generate savings. Most of those surveyed preferred physical rather than human services, such as social and library services, to be tendered (Municipal Association of Victoria 1995b).

Annual reports on the operations of the Department of Defence's Commercial Support Program have been made to the Parliament. However, they have not focussed specifically on compulsory competitive tendering.

Compulsory competitive tendering has been operating for some UK local government services since 1980, but its scope was greatly extended in 1988. Since then, there have been several studies assessing its impact on the provision of local government services.

Imposing competitive tendering: the benefits

Inquiry participants put the view that the main benefit of compulsory competitive tendering is that it accelerates the rate at which CTC is introduced and achieves the gains of CTC more quickly. For example, in the Institute of Municipal Management (Victorian Division) submission, Mitchell Shire Council in country Victoria considered that compulsory competitive tendering led to considerably greater benefits than those resulting from earlier, internally driven reforms:

Senior staff at the Shire of Benalla started driving cultural change about three years ago. This included formal staff appraisal schemes, involvement of staff in decision making and a real attitude of valuing staff suggestions and input. The change in staff attitude was pronounced, and senior management were very happy with the apparent results.

Gains made by these processes paled into insignificance when compared with the change brought about by competition. In-house bidding from small construction and maintenance projects was included over a period of nine months in 1994 and the increase in productivity caused by this process was dramatic. (Sub. 237, p. 8)

The Civil Contractors Federation agreed, noting that progress has been the most significant where compulsion has been introduced, such as in Victorian local government (Sub. 252, p. 2).

The City of Melbourne argued that, without compulsion, reform would not have been achieved in Victorian local government and for this reason, supported compulsion:

... compulsory competitive tendering was necessary because left alone, local government would never have achieved any reforms. ... Most other councils had not got themselves into the position that we had by the end of the eighties and were largely content to continue to increase their taxes on their local communities without, at the time, great resistance to that. (Transcript, p. 1475)

Brimbank City Council (Vic) also supported the use of CCT:

... local government and its service users will benefit from the Compulsory Competitive Tendering requirement facing the industry. The benefits will take many forms covering efficiency, effectiveness, improved standard, range and availability of services, and public accountability. (Sub. 41, p. 2)

From outside Victoria, the Hobart City Council, while not explicitly supporting compulsory competitive tendering, considered that the reluctance of local government to reform may have led to the introduction of compulsion:

It may be fair to say that local government has traditionally been (perhaps due to the very nature of its charter), one of the most insular sectors within the Australian economic and political framework and the one least open to change. Attempts at introducing voluntary changes through rationalisation, regionalisation, and modernisation have, with small but perhaps overly heralded exceptions, been largely unsuccessful. ... One might suspect these radical measures were taken to overcome the fairly entrenched resistance to change evidenced when the topic of amalgamations was raised some years ago. (Sub. 153, pp. 2-3)

Serco argued for greater competition for government business enterprises, similar to competition policies affecting the private sector:

Because Australian Governments have had no reservations whatsoever about mandating effective competition in the private sector and in services delivered by Government Business Enterprises it is therefore curious to Serco that the Commission falls short of recommending that all government services should be procured through contracting-out process when a multi-supplier market [to the end consumer] cannot be created. (Sub. 303, pp. 2-3)

Compulsion has been comprehensively assessed in the UK. The main findings of two recent studies which examined the overall effects of compulsory competitive tendering are summarised in box C2.1.

On the basis of the Audit Commission's findings, it seems that the anticipated introduction of compulsion increased the use of competitive tendering before the promulgation of the Act. The Walsh and Davis (1993) study also indicated that, although compulsion brought forward the benefits of CTC, it also brought forward some costs associated with CTC.

Box C2.1: Impact of compulsory competitive tendering in UK local government

The difficulty of separating out the effects of compulsory competitive tendering (CCT) from other factors which improve service effectiveness and efficiency was noted in the most recent study of the impact of CCT on local government in the UK. The UK Audit Commission surveyed two-thirds of local authorities in England and Wales. In the area of refuse collection, the only service for which aggregate data was obtained, costs fell by over 40 per

cent between 1980 and 1994. Most of the gains were made before CCT was introduced for refuse in 1988. Although CCT has contributed to these gains, the Audit Commission concluded that it was difficult to quantify the impact of CCT due to other factors reducing costs, such as technological change. Also, some councils were more successful than others in implementing CCT.

A detailed study by Walsh and Davis of the experiences of 40 UK councils with CCT concluded that the average overall reduction in costs due to CCT was 6.5 per cent. The main gain from introducing competition was the 'impetus of organisational change and service review'. Competitive pressure led to improved service monitoring and management. The second gain was improvement in local governments' knowledge of service quality and costs. Because of the focus on quality, there was a tendency to improve or at least attain standards that had been specified. However, competition can lead to a more complex and, to an extent, less flexible system, with increased bureaucracy and more formal procedures. That in itself has cost implications.

Sources: Audit Commission 1995; Walsh & Davis 1993

Imposing competitive tendering: the costs

Many inquiry participants, particularly local governments from outside Victoria, were very critical of the use of compulsory competitive tendering. The main criticism was that CTC may not be the most cost-effective reform option because in some cases its costs would exceed the benefits.

For example, Redcliffe City Council in Queensland argued that a central government directive would ignore the different costs facing individual councils and undermined local government functions of governance:

... the Council is firmly of the view that it is in the ideal position to know what is best for its community which it is elected to represent, having regard to all competing interests and local factors, and is therefore able to make the right decisions regarding the type, level and quality of local government services to be provided. Whether a particular service is suitable for contracting out and whether it should be contracted out, is best left to the discretion of each local government. (Sub. 18, p. 2)

Both the Local Government and Shires Associations of NSW and New England Local Government (NSW) strongly opposed the imposition of compulsory tendering. The former opposed compulsion which it was concerned would reduce the quality of council services (Sub. 290, p. 9). New England considered that the costs of rural councils acquiring the necessary tender evaluation skills would outweigh the benefits of compulsory competitive tendering (Sub. 258, p. 2).

Compulsion was a particular concern for those in areas where limited competition may result in higher service costs. Walcha Council in NSW stated:

It is not always possible to obtain the services of contractors in isolated areas, nor to get them when they are needed and so works programs can be unnecessarily impeded and delayed. Council plant and staff are always available. ... In the interests of rural Australia and in particular, small communities such as Walcha, we ask that the Commission dismiss any proposal to introduce compulsory tendering for Local Government. (Sub. 161, p. 2)

Best Practice, a management consultancy, argued against compulsion because CTC is only one management tool, and not necessarily the most cost-effective one:

Every attempt should be made to avoid a prescriptive approach to contracting the provision of government and local authority goods and services. Contracting out must be just one of a menu of service delivery options available to public sector executives. (Sub. 26, p. 23)

In Victoria, Surf Coast Shire expressed concerns with the pace of reform:

There has been a view put that CCT has been forced upon local government in Victoria as a matter of haste. Also, the legislation and regulations that surround CCT in Victorian Local Government are over prescriptive and administrative intensive. Any efficiencies gained from CCT may be lost in the administrative process. (Sub. 4, p. 1)

Similarly, the Municipal Association of Victoria (MAV) was concerned about the effects of compulsion:

The introduction of compulsory competitive tendering (CCT) in Victorian local government has successfully resulted in a thorough review of council activities. However, the current preoccupation with meeting CCT targets has the potential to inhibit the long term delivery of the benefits expected from CTC processes. (Sub. 302, p. 1)

Compulsion: an assessment

It seems to the Commission that it is too early to reach any firm empirical conclusions regarding compulsory competitive tendering in Australia. In Victoria, the MAV will be assessing the effects of compulsion (Sub. 302, p. 5)². Nonetheless, some observations can be made.

Imposing the use of this particular management tool may result either in too much CTC being undertaken in individual agencies or, depending on the type of compulsion, in particular services being inappropriately subject to CTC. These factors need to be considered against the benefits that may be obtained from

² The MAV is formulating a strategy to assess the effects of compulsory competitive tendering in Victoria and expects the review to commence early in 1996.

overcoming institutional resistance and moving from an inappropriately low level or a narrow range of services subject to CTC.

Competitive tendering and contracting is not an end in itself. Rather, it needs to be considered in the broader context of public sector reform. When other reforms are operating effectively, it should not be necessary to mandate the use of a particular management tool such as CTC. However, compulsory competitive tendering may be the best available option when:

- **existing institutional features are likely to delay reform;**
- **there is a history of unsuccessful or slow reform of activities that could be suitable for competitive tendering; and**
- **the benefits of CTC are likely to substantially outweigh the costs.**

Types of compulsion

Where governments judge that compulsory competitive tendering should be adopted, a further issue is the form it should take. In Victoria, compulsory competitive tendering of a specified share of total budget expenditure has been applied to all local governments. In the UK, the approach was to nominate specific services delivered by local government to be compulsorily tendered.

Most council submissions to the Victorian Local Government Board (1993a), which reported to the Victorian Minister for Local Government on compulsory competitive tendering prior to its introduction, supported the share of total budget approach, arguing that councils would be in the best position to assess where the greatest efficiencies can be made. For this reason, the Victorian Government preferred to specify expenditure shares rather than services for competitive tendering (Victorian Hansard 19/4/94).

By specifying particular services, agencies may also be discouraged from thinking innovatively about how to bundle services for tendering most effectively. This issue is discussed further in Chapter C4. The UK Audit Commission considered that competition can increase if thought is given to the size and packaging of services to be tendered (Audit Commission 1995).

In contrast, Dr Ernst of the Victorian University of Technology prefers requiring specific services to be competitively tendered rather than shares of total expenditure. He argues that prescribing services has the benefit of tendering services for which markets already exist and excludes more 'complex and sensitive human services' from the competitive process (Rance 1995). This argument is more about setting a compulsory level of competitive tendering which takes market conditions and service complexity into account when establishing which services would be competitively tendered.

Several Victorian local governments raised some operational issues regarding the Victorian arrangements. For example, the City of Port Phillip observed:

The requirement to include depreciation and debt servicing in calculating Council's competitive tendering targets, means almost 70 to 80 per cent of Council's discretionary expenditure (predominantly labour) will need to be subject to market testing through competitive tendering. (Sub. 73, p. 2)

This may be a concern for local governments in rural areas whose largest expenditure item is road building and maintenance. Depreciation and debt servicing for such councils may be a large proportion of their expenditure and the proportion of their operating expenses to be tendered, when these costs are excluded, may be much higher than 50 per cent.

The final report of the Victorian Local Government Board discussed the possibility of exemptions but supported the definition of 'total budget expenditure' because of its administrative simplicity (1993b). In this respect, the MAV noted:

A review of the Victorian CCT targets is now necessary, especially with respect to the effects of depreciation and the changes to the Australian Accounting Standards. ... An evaluation of the effects of conforming to the 50 per cent target in 1996/97 is both urgent and necessary for the continued evolution of the CTC process. (Sub. 302, p. 4)

The Victorian Minister for Local Government is prepared to reconsider the basis on which the targets for compulsory competitive tendering are set if the current definition hinders councils' ability to meet the targets (Victorian Office of Local Government 1995, p. 18).

The Commission considers that the percentage of expenditure to be tendered and the appropriate base to which the percentage should apply can only be determined within each jurisdiction. However, the proportional approach to compulsory competitive tendering is preferred to requiring particular services to be tendered. A difficulty with requiring specific services to be competitively tendered is that the agency prescribing the particular services, especially if it is removed from or has little experience in their delivery, may not be able to identify those services which would benefit most from being competitively tendered.

A central agency may not be best placed to identify the services which will benefit most from being competitively tendered.

Recommendation C2.2

The Commission does not advocate compulsory competitive tendering. However, if governments choose to adopt it, they should base it on a percentage of total expenditure, rather than nominate specific services to be tendered.

C2.4 Conclusion

Centrally developed CTC-specific guidelines increase the emphasis on the use of CTC as one method of public sector reform. They also help public sector managers address issues which are not covered sufficiently by general purchasing policies.

CTC is only one reform option available to the public sector, and some agencies implement it more effectively than others. Compulsion can hasten the achievement of the benefits of CTC, including reviewing the effectiveness of government services and focusing public sector managers on service outcomes, more quickly than other reform options — but it can also impose costs. To date, compulsion has been used when the effectiveness of other reform options has been limited and the potential gains of CTC have been considered to be large.

C3 ASSESSING THE SCOPE FOR CTC

C3.1 Introduction

The Commission was asked to develop ‘a set of indicative principles for public sector managers to use in assessing the scope for contracting out’ (terms of reference 3j). The Commission has interpreted ‘the scope for contracting out’ to cover two questions: what ‘can’ be subject to competitive tendering and contracting (CTC); and what ‘should’ be subject to CTC. In practice, the distinction between these is likely to be blurred as managers are most likely to be assessing both at the one time.

It is not intended to give prescriptive and detailed guidelines at an agency and manager level. This chapter will develop a framework within which managers can make decisions about CTC; identify some of the risks they need to be aware of when considering CTC; and outline a decision-making process for them to identify and evaluate appropriate candidates for CTC.

In this exercise the Commission has drawn on a wide range of guidelines and indicative principles for assessing the scope for CTC which have been developed by a number of governments and agencies. These include those developed by the governments of New South Wales, Victoria, Western Australia and South Australia, and suggestions for indicative principles presented in submissions by a number of agencies including the Commonwealth Department of Administrative Services (DAS), as well as those contained in the Department of Defence’s Commercial Support Program (CSP) manual.

One threshold issue in the discussion of the appropriateness of CTC is whether there are general boundaries to the use of CTC as a management tool.

While most would accept that functions such as law-making, coercive powers and governance are properly the province of government, there is little consensus beyond this point.

The Commission does not propose to enter into the debate as to what the role of government should be. But it does note that the question of the appropriate scope for CTC is different from the question of the appropriate role of government. As noted in chapter A1, CTC is not about privatisation because under CTC the government retains control over service provision including, the choice of which services are provided, at what level and in what manner.

There are, however, some constraints on when governments can use external agents to provide services. These constraints are discussed later in this chapter and include international, constitutional or other legal commitments.

CTC can be distinguished from direct internal provision by two defining characteristics. First, there is usually organisational separation of the roles of the purchaser of the services and the provider, sometimes referred to as 'the purchaser/provider split'. Second, delivery of the service is made contestable. In many ways, assessing the scope for CTC involves establishing the feasibility and desirability of these two arrangements.

C3.2 The CTC context

C3.2.1 Goals of the agency

Because CTC is a means to an end rather than an end in itself, it should be used only where it provides the most efficient and effective means of achieving an agency's objectives. As DAS stated:

Assessing the scope for contracting out is perhaps the wrong way of looking at what is essentially a decision about how best to manage a particular function or functions. Contracting out is one of a number of options, albeit an important option, which managers should consider when reviewing the efficiency and effectiveness of programs, and considering the best way to improve them. (Sub. 140, p. 11)

The NSW Government also said, in reference to its CTC program:

A key principle of the policy is that there must be a net benefit if contracting is to proceed. Decisions on the retention or contracting of tasks must be based on determining the option that will contribute most to the efficient, effective and proper achievement of the organisation's mission. (Sub. 199, p. 1)

The potential of CTC to enhance the achievement of an agency's goals should form the basis of any assessment of the scope for CTC. The goals of the agency may well be broader than ensuring the greatest value for money is achieved in the provision of narrowly defined services. These goals have often been implicit, and the CTC process, in common with other management reforms, requires them to be made explicit. For example, some local governments place a high value on promoting regional growth through their operations.

Several participants commenting on the draft report suggested that agencies should take into account a broad range of factors and require a separate 'social impact statement' as part of any assessment of the scope for CTC (see, for example, the Royal Institute of Public Administration Australia (Sub. 251), the Australian Liquor, Hospitality and Miscellaneous Workers' Union (Sub. 245)

and the Australian Education Union (Transcript, p.1144). While views on the scope of such a statement varied, essentially it would separately examine the impact on introducing CTC for a service on a range of broader government objectives (over and above an agency's service-specific objectives), including those objectives which the agency alone has little ability to achieve to any significant degree.

The Commission favours explicitly identifying and incorporating all objectives — both service-specific and broader government — which the agency is able to achieve, into an integrated framework, rather than using stand-alone social impact statements. This approach can enable an agency to consider the costs and benefits of the three options of:

- retaining the status quo in delivery of the service;
- introducing CTC, specified in a way which requires contractors to meet the relevant broader objectives; and
- introducing CTC in a way that focuses on service-specific objectives, where the agency retains the option of meeting its broader objectives through other policy means.

This integrated framework has two advantages:

- it focuses the consideration of CTC on the agency's explicit objectives; and
- a range of options for meeting any broader objectives and their costs (rather than just whether to introduce CTC or not) can be examined.

Where introducing CTC is likely to have an adverse effect on the broader objectives which can only be ameliorated at some expense, a separately costed two-envelope approach may be suitable (see chapter B6 for a discussion of these issues in the context of regional and industry development objectives).

Consequently, the discussion below and the guidelines outlined are confined to the considerations from the perspective of an individual agency's explicitly identified goals (see chapter B5 for a discussion of the broader social and distributional considerations).

A review of programs and activities, with the objective of matching them to the agency's goals, was cited by many participants as an essential first step in assessing the scope for CTC. For example, the South Australian Government CTC implementation principles begin by stating that, through an appropriate strategic planning process, all activities should be reviewed with the objective of determining whether the service is required and the most efficient method of delivery (Sub. 123, appendix A).

The Victorian Government submitted:

When assessing the scope for contracting out there needs to be an understanding of the organisation and its objectives and how those objectives can be best met. (Sub. 215, p. 26)

There are a number of benefits in this approach.

First, it helps to identify exactly which policy goals (from the narrow service-specific to the broader community goals) each program or activity is attempting to achieve. Agencies need to consult customers and other stakeholders about the services that are required to meet policy objectives.

Second, it identifies exactly what activities (including Community Service Obligations which may not have been explicitly identified previously) are currently being performed by an agency. Hobart City Council said:

Local councils need to identify base service levels. There is a surprising lack of knowledge (and particularly documented knowledge) amongst management as to the exact nature and extent of the tasks performed operationally. (Sub. 153, p. 18)

Third, it can assist in identifying those areas where services are ineffective in meeting the policy goals. The Department of Industry Science and Technology commented:

The use of contracting out needs to be seen as part of the overall strategy of organisations in meeting their goals. The way activities are undertaken has the potential to add to their effectiveness The task of reviewing an activity brings into focus the objectives and goals and strategies to be employed. (Sub. 156, p. 4)

Once the goals of the agency have been explicitly identified, they become an integral part of the assessment of the scope for CTC.

C3.2.2 Broad approaches to assessing the scope

Is it effective to identify categories of services which should or should not be subject to CTC, or is it more effective to decide the scope for the use of CTC on a case-by-case basis?

Broad categorisation

Several state CTC guidelines and some submissions to this inquiry suggest that the scope for using CTC can be based on a categorisation of services. A number of submissions attempted to nominate particular services (such as cleaning, refuse collection or security) which would be most suitable for CTC. Other submissions argued that agencies' services could be divided into 'core' and 'non-core' activities (or other such definitional approaches).

For example, guidelines developed by some state governments state that the core business of the agency should be considered in assessing the scope for CTC.

The Commission has not, however, been able to find robust, generally applicable definitions of categories of services suitable for CTC or a consistent framework for deciding which services belong in which category.

In the discussion of core and non-core services, there have been few attempts to define precisely what is meant by terms such as 'core', 'non-core', 'strategic' and 'peripheral'. Often 'core' is defined in terms of the agency's main areas of operations or is simply given as a list of particular activities which should be considered core, rather than establishing the characteristics which make those activities core and others not. Responses to the survey of Commonwealth budget sector agencies commissioned for this inquiry also suggest that the term is not well understood (see appendix D). Quinn and Hilmer found a similar problem in the private sector discussion of 'core':

Unfortunately, most of the literature on the subject is tautological — 'core' equals 'key' or 'critical' or 'fundamental'. (1995, p. 50)

They also commented that this did not provide a guide to managers on what activities their organisations should concentrate.

For example, many see policy advice and regulation as core functions of government. But governments have often contracted out aspects of these activities. In the case of policy advice, recent examples include the National Competition Policy Report (Hilmer et al, 1993), and the National Savings Report (FitzGerald 1993). While governments will always wish to retain an independent source of policy advice, there is scope for at least some of the activities associated with this function, such as the analysis of policy issues or the development of policy options, to be contracted out. In the case of regulation, while not being explicitly contracted out, it is conducted by the private sector with the recognition and support of government in many cases (eg self-regulation by the professions, and industry codes of practice).

Several participants (eg Australian Education Union (Sub. 286), National Tertiary Education Industry Union (Sub. 279), the Brotherhood of St Laurence (Sub. 312) and the Australian Council of Social Service (Sub. 310)) argued that their industries were characterised by inherent qualities which should wholly or largely preclude them from consideration for CTC. However, many of the services in these industries have a long history of being delivered, not by government, but by community organisations on the government's behalf.

It is important to recognise the difference between governments' responsibility to have certain services provided and the physical delivery of those services. The categorisation of services often fails to make this distinction.

Another problem with the categorisation of services into those which should or should not be subject to CTC is that the environment in which a service is provided changes over time. As the Commonwealth Department of Employment, Education and Training (DEET) stated:

The decision to contract out needs to be responsive to the needs of the organisation and changing business practices. ... This can mean that what was once considered too critical to outsource, may in the future be considered non-core in nature and suitable for outsourcing. (Sub. 230, p. 4)

The Commonwealth Department of Veterans' Affairs also found that its role changed over time, which necessitated a change in the way its services were delivered (Sub. 110).

Factors which may cause changes in the definition of core functions include changes in governments themselves, changes in policies within those governments, advances in technology, or changes in social and economic conditions.

Yet another problem with isolating categories of services suitable for CTC is that they may not recognise that what is of strategic importance to one agency, may be relatively unimportant to another. For example, Commonwealth Funds Management stated that its core activity is the intellectual decision-making of managing investments (Sub. 117), while the Commonwealth Scientific and Industrial Research Organisation said that its core business is research and transfer of research results to customers (Sub. 24). Those same activities would be peripheral to other agencies' functions.

There may also be differences between the importance of particular activities to agencies and to their governments. As the Western Australian Government's guidelines state:

... activities considered to be strategic by individual agencies may be considered to be non-strategic by government. (Western Australian PSMO 1995, p. 6)

Furthermore, categories of service will not necessarily recognise that the reason for the unsuitability for CTC may apply to only one aspect of a service. There may be different activities within a function for which the need for direct government delivery may vary. For example, there may be privacy or confidentiality aspects related to some of the activities involved in distributing social security payments, but it is unlikely that all of the activities involved in that distribution would have these aspects.

The lack of success in developing broad categories of services which are suitable or unsuitable for CTC indicates a more fundamental problem.

There are a number of characteristics of some services which may make it more difficult to use CTC (such as privacy, accountability or consumer redress requirements), but it is difficult to define absolute restrictions. There will always be trade-offs between the costs and benefits of managing those issues internally and the costs and benefits of managing them through external providers. Governments have faced these trade-offs in the area of regulation, and there are a range of examples where they have chosen not to undertake regulatory oversight internally. For instance, self-regulation applies to the professional standards of accountants and medical practitioners, and aspects of industries such as consumer banking and commercial television¹.

In addition, the risks involved and the external and internal management costs will be different for each service and each agency. Moreover, those costs will change over time. It is therefore extremely difficult to formulate broad categories of services or to nominate characteristics of services which will make them more or less suitable for CTC for a wide range of agencies. Such decisions need to be made on an individual basis.

Case-by-case approach

These problems with broad categorisation approaches to assessing the scope for CTC suggest that it is essential to take a case-by-case approach within an agency. Functions should not be pre-ordained as being suitable or unsuitable for CTC without careful consideration of what it is about those functions that determines their suitability or otherwise.

One of the benefits of taking such an approach is that it can bring into consideration services or activities which may not have been adequately considered when broad categorisations are made. Nominating CTC for particular services such as cleaning or gardening because they are “non-core”, without looking at other functions as well, may mean that activities where considerable gains are possible, may be passed over.

The Commission concludes that the scope for CTC should not be considered on the basis of broad categorisations of services or characteristics of those services. Instead, assessment of the scope for CTC should be made on a case-by-case basis.

¹ The banking and commercial television industries are subject to the *Code of Banking Practice* and the *Commercial Television Industry Code of Practice* respectively.

C3.3 Identifying the constraints

As was stated at the start of this chapter, there are some functions which most people would agree are properly the province of government, such as law-making, coercive powers and governance. Most people would also agree that these functions must be carried out by public officials.

There are other functions where there may also be restrictions on the use of CTC. These restrictions may include international commitments, or may arise from constitutional or other domestic legal considerations. Prior to any assessment of the scope for CTC, any such restrictions should be identified.

Agencies should preclude from consideration for CTC only those activities specifically constrained, not activities related to them. For example, DEET noted that Australia is bound by an International Labour Organisation convention to provide services free of charge to job seekers (Sub. 230). However, this requirement does not mean that the government has to physically deliver those services — as shown by the Commonwealth Government's decision to introduce private sector employment case managers.

Once these absolute restrictions have been identified, it is then necessary to establish the framework for assessing the scope for CTC.

C3.4 Identifying the suitability for CTC

While determining the suitability of particular categories of services for delivery via CTC is not advised, it is important to establish some principles which may assist in identifying when CTC will be the best means of service delivery.

CTC should be used only when it is the most efficient and effective means of service delivery, but determining this can involve considering a large number of factors.

C3.4.1 Identifying the costs of internal provision and CTC

An important factor is the full costs involved in both internal delivery prior to CTC and delivery through CTC. The cost elements which should be considered are detailed in chapter B3 and the attachment to appendix E, and cover service costs, transaction costs and transition costs.

One of the benefits of CTC is that it incorporates its own assessment of service costs in the tendering process. The service costs of various tenders, including in-house tenders, can be readily compared with each other and weighed against their other relative merits. The service costs of various tenders can also be

weighed against the service costs of existing internal provision, providing they have been assessed properly.

Assessing the transaction and transition costs of CTC against management costs of existing internal provision is not as simple and will require detailed analysis based on the factors discussed in the following sections.

The comparison of the full financial costs of direct internal delivery and CTC should be made on a net present value basis and have regard to any changes in the range of services and/or their quality. However, as the effects of change may be felt for longer than the length of the individual contract, the time period over which the assessment should be made may be longer, say, five or ten years in the case of a three year contract.

Because conditions of services, agencies and markets change over time, agencies should periodically return to the consideration of CTC as a means of service delivery.

C3.4.2 Assessing risks and their costs

As was noted previously, what appears to underlie many of the attempts to categorise services into those suitable or unsuitable for CTC are assumptions about the risks involved with those services and the magnitude of the costs which would result from those risks.

Determining when it is appropriate to use CTC should involve an identification of the risks and an assessment of their costs. The underlying risk which has to be considered is that the CTC process will fail to provide the required service to the required standards at the contracted price.

However, it is not sufficient to simply identify risks and use them as a basis for ruling out the use of CTC. As Bankstown City Council put it, risks should not be treated as “a smorgasbord for inaction” (Transcript, p. 1906). An assessment of the probability, costs of the risks and means and costs of mitigating them should also be made.

In this respect, managers should seek the answers to a number of questions:

- what are the risks involved?
- what is the magnitude and potential costs of each of these risks?
- can these risks be reduced or avoided and what are the costs of doing so?
and
- after risk management strategies have been considered and costed, are the residual risks so great as to outweigh the benefits of proceeding with CTC?

The types of risks and costs can be grouped into those arising from:

- factors specific to the type of service being considered for CTC;
- aspects of the market in which CTC would occur; and
- factors within the agency contemplating CTC.

Service-specific factors

The characteristics of services being considered for CTC may create particular risks and thus costs, which need to be considered in assessing the scope for CTC.

In certain services there may be accountability, privacy, security, consumer protection, access and equity or other special policy considerations which need to be taken into account. The likelihood and magnitude of any costs arising from these factors (some of which are discussed in chapters B1 and B5) should be assessed. So too should the potential for and costs of addressing them through contract specification, contractor selection and contract management, including performance monitoring — see chapters C6 and C7.

However, in undertaking that assessment, agencies should heed the warning of the Management Advisory Board — Management Improvement Advisory Committee (MAB/MIAC):

... agencies will need to take care to avoid the tendency to classify almost every activity as not warranting consideration for competitive tendering because of public interest, accountability and control issues. This would forego the benefits that have been shown to flow from competitive tendering. (1992, p. 33)

Several of the existing guidelines and indicative principles include consideration of these factors. For example, the indicative principles suggested by DAS (Sub. 140) state that managers should consider any special need for accountability, security or privacy. The Western Australian guidelines state that, regardless of who wins tenders, government will retain control and accountability.

An assessment also needs to be made of the scope to specify services in terms of outputs rather than inputs, and of the ease of measuring outputs for purposes of contract management, including performance monitoring. For example, it may be easier and less costly to specify the required outputs in repetitive tasks, such as mail sorting, than in tasks like information technology services. The guidelines developed by the NSW Government state that the case for contracting is stronger, the more precisely the task can be specified in advance and the less there is a need to specify the means of service delivery.

Another service-specific factor which should be considered is whether the service is one where interruptions to its delivery would incur a very high cost. The delivery of certain services to hospital theatres would be an example. In such a case, the likelihood of service failure, the costs of that failure and the costs of any remedial measures, should be assessed.

The importance of this factor has been noted by a number of governments. For example, the Victorian Government guidelines note that special planning and consideration may be required where the service must be provided on a continual basis and interruptions cannot be tolerated. The Western Australian Government guidelines state that due caution must be exercised where there is high risk of service failure and the consequences of failure are significant.

Market-specific factors

Chapter B3 identified competition and contestability as the driving factors behind the benefits from CTC. It follows that where a service is put to tender in a market which does not display competition or contestability, the benefits of CTC may be reduced.

A related problem of using CTC in a market with little competition or contestability is the possibility of service capture (as described in chapter C4).

Agencies should assess whether there is an established market for the delivery of the services being considered and the strength of the contestability or competition in that market. Where there is not an established market, the likelihood of a market emerging as a result of the service being put to CTC should be evaluated. For example, prior to the introduction of private employment case managers, there had been little activity in this market by the private sector. This market has now developed substantially (Sub. 278, p. 1).

The costs of weak competition and the transactions costs of steps to encourage competition should also be considered. All of these issues are discussed in chapter C4.

Several participants stressed the importance of judging the depth of competition in the market. For example, DAS stated that managers should assess the level of market interest and capability. The NSW Government guidelines state that the case for CTC becomes stronger, the greater is the competition between bidders. The Victorian Government submitted that CTC should be considered where a competitive market exists for the function. The Government of Western Australia's implementation principles include open and fair competition.

Another market-specific factor which needs to be considered is the potential for and costs of contractor failure, ranging from a failure to provide services to the agreed standard and cost, through to disruption of service because of business

collapse. For example, many construction contracts contain penalty clauses for late completion. The ease with which contractors can be penalised for unsatisfactory performance without significantly disrupting services should be assessed.

A number of jurisdictions have noted the importance of this consideration in the guidelines they have developed. For example, the NSW Government guidelines comment that the case for CTC becomes stronger, the more readily unsatisfactory contractors can be penalised or replaced without significant interruption to service delivery.

Agency-specific factors

The successful implementation of CTC requires that agencies possess or can acquire the requisite skills and knowledge to implement the CTC process, that is, prepare specifications, design tender systems, evaluate tenders, monitor performance and manage contracts. Chapter C8 discusses this matter.

Again, the importance of this factor has been noted by a number of agencies and jurisdictions. For example, the Victorian Government noted that care should be exercised in proceeding with CTC where the organisation has no experience with contracting out (Sub. 215).

Another major factor which needs to be considered by agencies is the likelihood and costs (both short and long term) of industrial disruptions. This aspect is covered in several existing guidelines. For example, the Department of Defence's CSP guidelines stress that staff and unions should be consulted. Chapter C8 examines the various human resource management issues involved in CTC, including consultation with employees and their representatives, and handling excess staff.

Yet another factor to consider is the magnitude of management resources which need to be committed to an internal activity relative to its importance in achieving the agency's goals. When an activity requires a disproportionate level of such resources, the case for CTC will be stronger. For example, while vehicle fleets are important to the operation of many government agencies, most agencies do not manage their own fleets. In part, this may be because such a function could be very costly in terms of management time, while adding little to the achievement of the agency's goals.

C3.5 Conclusion

The Commission does not support the approach of categorising services into those which are and those which are not suitable for CTC, primarily because it

could find no robust, generally applicable method of putting particular services into one or the other category.

Rather, the Commission considers that each service should be examined on a case-by-case basis. It has developed the following set of indicative principles (see recommendation C3.1 overleaf) which it recommends for the use of governments and their agencies in assessing the scope for CTC. In doing so, it recognises that a number of them have included many of these principles in their guidelines.

Recommendation C3.1

Governments and their agencies should assess the scope for competitive tendering and contracting on a case-by-case basis. In doing so they should consider the following indicative principles.

The process takes time and is not costless. The degree of formality agencies attach to it should depend on the complexity of the services involved and the likely cost of their delivery. The items listed should not be used as an excuse for inaction but they should be considered carefully in each case.

A Identifying the constraints

- Identify any functions which for constitutional or other legal reasons or because of international commitments, must be carried out by public officials only.

B Reviewing functions

- Identify the functions of the agency in terms of its policy goals.
- Consult customers and other stakeholders about the services that are required to meet these policy goals.
- Assess whether the existing services meet requirements and determine whether the range of services and/or their quality should be changed.
- Assess the full costs and benefits of the existing method of service delivery.

C Identifying the alternatives

- Where the function is new to the agency, consider CTC as a possible means of delivery from the outset.
- Identify other service delivery options.
- Compare the other service delivery options with the existing method. Depending on the size and importance of the activity and the likely benefits to be gained, this may require a formal process such as benchmarking or less formal processes.
- Make some assessment of the likely net costs of the CTC process.

D Assessing the suitability and risks of CTC

CTC involves a number of risks. This should not preclude its use. However, the likely cost of all the risks and ways to minimise them should be assessed. The following questions should be addressed (not necessarily sequentially), to enable an overall assessment to be made.

Service-specific factors

- Are there any accountability, privacy, security, consumer protection, access and equity or other policy considerations that cannot be addressed satisfactorily through contract specification and contract management and performance monitoring? The less difficult these considerations are, the greater is the case for CTC.
- How easy is it to specify the service (particularly in terms of outputs rather than inputs), measure the output of the service and measure the performance of the contractor? The easier these things can be done, the greater is the case for CTC.
- How serious are the consequences of service interruption arising from contract failure? How likely is such a failure and is there any way to minimise this likelihood or the costs of interruption? The less important these factors are, the greater is the case for CTC.

Market-specific factors

- Is there an established market for delivery of the service and what is the level of competition or potential competition in that market? The stronger an established market is, the greater is the case for CTC. If there is not an established market, assess the likelihood of a market developing and its competitive strength.
- How easy is it to penalise contractors or replace them for unsatisfactory performance without significantly interrupting service delivery? The easier it is to penalise or replace contractors, the greater is the case for CTC.

Agency-specific factors

- Does the agency have, or have access to, the skills required to draw up specifications, evaluate tenders and manage the contract? The case for CTC is greater where those skills are available or can be obtained.
- What are the likely industrial relations implications of moving from direct government delivery to CTC? CTC is easier to implement where it is less likely to cause industrial disruption.
- Would CTC reduce the management resources used in providing services which are less important in achieving the agency's goals? Where the service takes up a disproportionate amount of management resources, the case for CTC is stronger.

E Weighing the costs and benefits

- Assess the likely full costs of CTC, including the costs of service delivery, transition costs and contract monitoring and management costs.
- Make an overall assessment of the costs and benefits of CTC compared with other service delivery options. This comparison should be made on a net present value basis.

C4 PROMOTING FAIR AND EFFECTIVE COMPETITION

C4.1 Introduction

Competition is perceived by many as the central force driving the benefits of competitive tendering and contracting (CTC) for service provision. Indeed, earlier sections of this report (chapters B2 and B3) pointed to the important role competition plays in encouraging improvements in service quality and client satisfaction, innovation in service delivery and cost reductions.

In some cases, merely exposing existing service providers to the real prospect of competition will have benefits. For example, a recent study by the Department of Finance (1995b) of several Commonwealth Government agencies found that increased contestability can have a positive effect on the efficiency and quality of service delivery.

Introducing competition into the delivery of government services can be achieved in a number of ways — for instance, through benchmark comparisons with external suppliers or through a competitive tendering process. Even within this latter option, the extent of competition may be affected by the characteristics of the relevant market or the specifics of the tender process.

The aim of competitive tendering should be to employ competition to improve service delivery outcomes. Competition is not an end in itself, but a means to an end. Importantly, effective competition does not always require frequent re-tendering or a market of many firms. Moreover, the benefits of encouraging a greater level of competition must be weighed against the costs of doing so. For example, the CTC process can be expensive in itself.

This chapter examines a range of issues which impact on the prevailing level of competition. At a broad level, these issues can be divided into:

- service specification considerations;
- the nature and characteristics of the contractual relationship; and
- the probity and integrity of the competitive tendering process.

Drawing on the experiences of a range of agencies, contractors and other interest groups, this chapter develops a range of ‘best practice’ suggestions to assist agencies in ensuring that an appropriate and effective level of competition prevails. The treatment of in-house bids is discussed in chapter C5.

C4.2 Contract size and length

The degree to which competition is present in the tendering of services depends, in part, on the size and scope of the activity, the length of the contractual relationship and the availability of alternative providers of the service. However, the level of competition is only one consideration relevant to the choice of contract size, scope and length. Other factors, including transaction costs and the nature of the service should be taken into consideration.

C4.2.1 Contract size and scope

The size of the contract may discourage, or even prevent, certain persons from participating in the tender process. For example, grouping a number of service requirements (say, cleaning services for all metropolitan schools) into one contract, may effectively prevent smaller organisations from competing. In this sense, larger contracts (in size or scope) may indirectly reduce the level of competition during tender processes.

Similarly, by grouping complementary services into one contract, organisations specialising in individual facets of the service may not be successful as stand-alone suppliers due to a lack of expertise or experience in other service aspects. For example, a specialist construction company may not have the capability to undertake a complete design, construct and maintain project on its own.

The Civil Contractors Federation (CCF) commented that there tend to be fewer potential tenderers as contracts increase in size and complexity (Sub. 252, p. 5).

ALLCO IT Finance Division recommended the unbundling of contracts to facilitate access for specialist firms:

‘Unbundling’ the finance and asset ownership components of an outsourcing contract has at least three major benefits: ... unbundling reduces the cost of service, ... unbundling removes the major source of risk exposure to government, [and] ... unbundling opens up the market to all firms, not just those with multinational balance sheets. (Sub. 46, p. 9)

Larger contracts were also suggested to be inappropriate for some services, where the most efficient outcome involved a larger number of suppliers. For example, the Small Business Development Corporation submitted:

In some cases it may be more efficient to break tenders down into smaller components and deal with a larger number of small to medium sized firms, than give the entire contract to one firm or agency.

Anecdotal evidence suggests that Transperth receives a better quality and more responsive service from smaller firms. (Sub. 103, pp. 1-2)

At the Commonwealth level, the Department of Administrative Services (DAS) recognised that large tenders can disadvantage small to medium-sized enterprises (SMEs), particularly if unrealistic response time-frames are imposed. DAS noted that encouragement for SME involvement is provided through the (Commonwealth-wide) requirement that all tenders over \$10 million include a statement of SME involvement (see appendix B). A recent study conducted for Purchasing Australia (1995b) discusses the difficulties faced by SMEs in obtaining government contracts.

The Employment Services Regulatory Authority (ESRA) has opted for smaller contracts in tendering for case management services for job seekers, since this is considered to encourage greater regional competition (Sub. 278, p. 3). ESRA considers that encouraging a larger range of service providers allows a greater choice of service type and quality.

However, the administrative or transactions costs associated with the CTC process must also be taken into consideration. These costs — including advertising expenses, the costs of identifying service requirements, preparing tender documentation, evaluating alternative offers and managing the winning contractor — may have a ‘fixed’ element. This suggests that the costs of tendering (and contracting) increase less than proportionately to increases in the value of the contract. Consequently, smaller contracts may incur proportionately higher administrative costs than larger contracts. Indeed, DAS submitted:

Generally speaking, one large tender will involve lower administrative costs than a number of small tenders for buyers and suppliers. This approach minimises the costs to suppliers entailed in bidding for government business, while it can also considerably simplify the process of tender evaluation and contract management for buyers. (Sub. 140, p. 46)

Serco Australia echoed this view, arguing that it was “more cost-effective to monitor large contracts than small contracts” (Sub. 144, p. 5).

Other benefits of larger contracts include the potential for bidders to offer innovative solutions regarding the integration of related or complementary services, sometimes referred to as economies of scope. For example, a single task contract may be contested by organisations with similar equipment and processes, leading to competition purely on labour costs and overheads, potentially diverting the focus of attention away from the quality of service. The converse is possible where complementary services are grouped together to allow the greatest scope for contractors to devise innovative solutions. For example, at the Puckapunyal Army Base, fire fighters engaged by Serco Australia also undertake printing duties.

Furthermore, larger contracts may provide greater scope for contractors to access the benefits of larger scale production. The South Australian

Government's contracting out of all State government information technology (IT) functions is intended to provide such benefits in terms of a uniform 'whole-of-government' approach to IT tasks, together with anticipated industry development benefits.

The Commonwealth Government's Information Technology Review Group (1995b) was critical of this approach, suggesting that it may have anti-competitive consequences. In contrast, Serco submitted that larger contracts encourage the maximum benefits of competition, primarily due to the greater returns a contractor can expect from them (Sub. 144).

Where larger contracts are tendered, the option remains for the winning bidder to subcontract at least some of the activities. For instance, the Tasmanian Government pointed out that large interstate companies often bid for work in Tasmania which they later subcontract to smaller local firms (Sub. 108).

This may result in the prime contractor, rather than the public agency, bearing the costs of managing a number of contracts. This may be particularly appropriate for those markets where the contractor is best able to manage these costs — through, for example, access to existing networks of suppliers or greater market knowledge. However, care needs to be taken to ensure that transparency surrounding the work standards of subcontractors is not reduced.

In other cases, joint bids — where individual (smaller or specialist) contractors form a consortium to tender — can enhance competition for larger service contracts. For example, even where only two or three consortia are tendering for a contract, to the extent that competitive pressures are present amongst firms vying for membership of these joint bids, an efficient outcome for the tendering process is likely. The South Australian Engineering and Water Supply Department issued Requests for Tenders to three consortia for its outsourcing of Adelaide's water and sewerage services. Each consortium consisted of multinationals teaming up with Australian-based firms. For example, the successful consortium included Compagnie Generale des Eaux, Thames Water and Kinhill as the Australian-based company.

In deciding how to 'bundle' services for tendering, a number of factors (for example the extent of economies of scale and scope) need to be taken into account. Agencies should also be aware that the size of the contract may discourage, or even prevent, certain persons from participating in the tender process.

Recommendation C4.1

Agencies should determine contract size on a case-by-case basis, with reference to:

- **the service and market characteristics (for example, economies of scale and scope and the potential for innovation);**
- **administrative or transactions costs (and whether the agency or an external contractor is best able to manage these costs); and**
- **the need to ensure effective competition.**

C4.2.2 Contract length

The length of the contract may influence the degree of competition involved in delivering a service. Difficulties in contract management and in anticipating all eventualities mean that longer contracts may carry greater risks of inadequate performance. As well, longer contracts may advantage incumbent suppliers and effectively lock out potential competitors (see below).

Long-term contracts may also reduce the policy flexibility available to governments. Specific services may be retained to satisfy contractual obligations, regardless of short-term imperatives or actual requirements. For example, by signing a long-term contract for the provision of a given level of vocational counselling services to unemployed clients, an agency may be locked into funding services at a particular level. This level may no longer be appropriate when unforeseen changes occur in that particular labour market. Similarly, longer-term contracts may bind the agency to a specific supply technology or process, restricting access to any benefits of technological developments. Waggamba Shire Council (Vic) noted that long-term high cost contracts can reduce flexibility, however they also emphasised that:

Contracting can improve responses to changing needs of the community. ... The use of contractors to help overcome peak demand or to avoid increases in employees [or] plant ... improve[s] flexibility by increasing the discretionary expenditure in the budget. (Sub. 19, p. 5)

Longer contracts may be appropriate where contractors are required to recoup investments over the period of the contract. For instance, the CCF submitted:

Where considerable capital investment is required the duration of the contract should be such that this investment can be reasonably amortised. (Sub. 53, addendum 1, p. 3)

Similarly, the Department of Defence commented:

One would not expect that a small contract to mow lawns ... be of any great duration. However, a contract for the maintenance and servicing of aircraft engines, [which] requires a large capital injection in plant, equipment and highly specialised staff [who] may need to be trained to perform the function, ought to be considered in terms of a lengthy period. (Sub. 81, p. 25)

Arguments for long-term contracts to recoup investments rest on the degree to which necessary investments in capital or labour training can be regarded as 'sunk costs', that is, costs not able to be retrieved at the completion of the contract. For example, while a printing contract may require a large investment in the purchase or lease of appropriate printing equipment, these costs need not be fully recouped during the period of the contract if there is scope to sell the equipment (or remaining term of the lease) at the end of the contract. Consequently, in deciding the length of contract needed to generate an appropriate return on investments, agencies should consider only those investments which are significant and sunk.

The Australian Council of Social Service considered that long-term contracts have the benefit of providing a more stable environment for research and development (Sub. 310, p. 18).

The ACT Government argued that, as there are costs associated with frequent tenders, it may be more effective to include an option or multiple option to extend a service contract. It noted that this approach is dependent upon a rigorous and sound tender process being adopted in the first place (Sub. 266, p. 11).

For social welfare services in particular, the Commission notes that long-term contracts may provide benefits in terms of continuity and stability in client-contractor relationships. In these services, the value of retaining a known and trusted provider suggests that longer-term contracts — with less frequent contractor change-overs — may provide a better outcome for service recipients. The National Anglican Caring Organisation Network noted:

Effective community service is more than a physical output — aged care is more than a bed or a meal, emergency housing is more than a roof. Both require security, feeling 'at home', and individual understanding. ... These are only gained over time in an area or with a clientele. Tendering cannot change providers in community service without substantial loss in these areas. (Sub. 220, p. 3)

ESRA agreed with the need for longer-term contracts in the area of social welfare services, in order to:

... provide some certainty and confidence among providers ... to encourage them to undertake investment and practice improvement. (Sub. 278, p. 4)

ESRA said that it is difficult to move jobseekers from one case manager to another since it disrupts the relationship (Sub. 278, p. 4). Nevertheless, as noted in the Commission's Report on *Charitable Organisations in Australia* (IC 1995d, p. 394), even for social welfare services, it is important to retain a mechanism to make their delivery contestable at appropriate intervals, so as to enable the contracting agency to weigh up the merits of alternative service providers.

Recommendation C4.2

Contract length should be determined with reference to:

- **the need for contractors to recoup significant sunk costs;**
- **the desirability of continuity of client-contractor relationships, particularly in community services;**
- **the possibility of fundamental policy changes affecting service provision; and**
- **the need to ensure an effective level of competitive pressure.**

Strategic alliances and long-term relationships

The concept of a strategic alliance between a government agency and a contractor assumes that, through access to a cooperative, longer-term, stable contractual relationship, the service provider is in a position to provide more efficient plant and equipment and more highly trained staff, and to acquire greater awareness of the needs of purchasers and end-users. These benefits may lead to improvements in service quality and effectiveness and/or reductions in service costs.

For example, a strategic alliance (sometimes referred to as 'partnering') between the agency and the contractor may improve the contractor's knowledge of the client's service requirements. A contractor may exhibit a sustained commitment to quality of service in the knowledge that a form of 'implicit contract' exists, in addition to any formal (explicit) contract (see box C4.1). However, it is important to note that implicit contracts are not exclusive to strategic alliance-type relationships, and can apply to a wide range of agency/contractor relationships.

Box C4.1: Strategic alliances: a form of implicit contract

Implicit contracts are agreements which are not legally enforceable, but are regarded as ‘self-enforcing’ because it is in the interests of both parties to abide by the implicit agreement. In the context of a strategic alliance, an implicit contract may take the form of the contractor acting in the client agency’s interests in the face of unforeseen circumstances, given the knowledge that these actions will be recognised and perhaps rewarded in the future by the client agency.

An example of such behaviour in the private sector was evidenced following the 1989 Newcastle earthquake. Without being contacted or required by contractual conditions to respond to such a situation, a number of private contractors were among the first people to arrive at the city’s K-Mart stores to assist with the necessary clean-up work.

A number of participants mentioned the benefits of a ‘partnering’ approach to contracting. For example, the Department of Defence submitted:

While the contract establishes the legal relationships, the partnering process establishes the working relationship between the parties. It attempts to create an environment where trust and teamwork prevent disputes, fosters a cooperative bond and facilitates the delivery of the goods or services to be provided under the contract. (Sub. 81, p. 27)

Defence suggested that a desire to develop such working arrangements has the potential to affect the length of the contract, involving “a longer than ... would normally be expected relationship between the customer and the service provider” (Sub. 81, p. 25).

Skilled Engineering also noted the benefits of a partnering approach, and the effects such a relationship could have on contract length:

The relationship is long term in nature with a clear understanding that neither party benefits from the exploitation of the other and both parties strive to achieve the declared goals and objectives of the business partnership. Innovation is encouraged and overall performance continually improves through the delivery of quality services to standards which are progressively raised by mutual agreement between the partners. (Sub. 69, attachment, p. 1)

Similarly, the City of Port Phillip noted:

Establishing this partnership between the contractor and the purchaser or the in-house provider and the purchaser is a fundamental key to maximising the future success of competitive tendering. (Sub. 73, p. 9)

The Commission recognises the benefits such working relationships may offer, particularly for services where:

- a high degree of dedication to quality is required from the contractor;
- a stable supply relationship is important;
- performance monitoring is difficult or costly; or
- a relatively high degree of uncertainty exists (including uncertainty surrounding the policy environment, technological development and future demand levels).

The characteristics of many human services — emphasis on quality outcomes, stable client–contractor relationships and difficulties in service specification and performance measurement — suggest a valuable role for ‘partnering’ in these areas.

Nevertheless, it is critical to ensure that the benefits of such relationships do not come at the cost of excessive reductions in competition. Further, given the long-term nature of contracts in many of these areas, alternative suppliers may raise concerns over the fairness and probity of the relationship between the client agency and the preferred contractor.

These concerns underlie the importance of encouraging open and effective competition during the initial tender process, and during periodic re-tendering. This requires that the agency retain the ability to switch suppliers if the existing contractor is not performing adequately or when the contract is retendered.

Contracting agencies also need to recognise the potential pitfalls of becoming too close to the contractor. Where an agency is perceived to have a relationship with the existing contractor which extends further than pure commercial dealings, potential contractors may question the probity of future tender processes. Problems may also arise in terms of perceptions of the agency’s willingness to apply sanctions or contractual penalties to a ‘partner’.

In large part, these types of problems may be overcome by ensuring that all decisions are made under transparent conditions. For example, allowing independent scrutiny of tender processes or evaluation decisions (using a ‘probity auditor’ or similar) may avoid perceptions of improper behaviour by contracting agencies. Also, by ensuring that all participants have equal access to relevant tender information, claims of favouritism or incumbency advantages may be alleviated. These issues are discussed further in section C4.3.1.

Strategic alliances or partnering can offer significant benefits, particularly for contracts requiring a high level of service quality, where continuity of supplier is important or where a relatively high degree of uncertainty exists. However, it is important to ensure that the benefits of competition

are captured through a contestable initial tender and through the ability to switch providers if required.

C4.2.3 Avoiding supplier capture

Monopoly markets and limited competition

The Commission recognises that calling tenders will not always guarantee effective competition. In some cases the characteristics of the market or the service may lead to relatively low levels of competition. In the extreme, the market may sustain only one supplier or be characterised by barriers to entry which restrict contestability.

In a market with limited competition, there are risks associated with contracting out skills and knowledge, or disposing of assets, that are difficult to regain or replace should this become necessary. In the extreme case noted above, a service previously provided through a public monopoly may be transferred through the tender process to a private monopoly provider. That may produce a range of problems — including reduced incentives for efficient production, unnecessarily high costs and poor service responsiveness.

Some participants submitted that where competition is limited, and particularly in smaller regional markets, tendering may result in private monopoly providers replacing existing government providers. For example, Kempsey Shire Council (NSW) suggested:

... in country areas ... there are few local tenderers and the risk of one or two monopolising the field with inherent future price rises becomes a reality. Once Council [loses] its expertise in the field and disposes of its plant, it is very difficult to start up again if the contractor becomes unsuitable for any particular reason. (Sub. 178, p. 3)

Markets where competition is limited may be subject to problems of predatory pricing or ‘low-balling’. In such cases, contractors may tender prices which do not cover costs, so as to establish some form of incumbency advantage (see the following discussion of incumbency advantages and the concept of a ‘winner’s curse’) or drive potential competitors out of the market. For example, the Local Government Association of Tasmania noted occurrences of:

... tender bidding ‘wars’ where suppliers appear to have cut margins to the extent that it was not possible to make money from the tenders. Firms use such ploys in attempts to ‘starve out’ newer or smaller competitors. ... [This may produce] ... good tenders in one year, followed by expensive ones in the next year — after internal resources have been disposed of ... (Sub. 132, pp. 7 & 11)

Likewise, the South Australian Council of Social Service (SACOSS) submitted:

Unusually low bids should not be accepted as they suggest either a lack of competence in establishing a bid, or an attempt to use assets to drive out other bidders and thus undermine future competition. (Sub. 58, p. 10)

There is a need to ensure that in those cases where competition is limited, ‘potential competition’ is maintained through appropriate bundling of service requirements. It has been suggested that large programs, originally performed by one in-house division within a local government, could be disaggregated into smaller contracts to facilitate wider interest amongst smaller firms. Indeed, the Hobart City Council noted:

In Tasmania, as with many rural areas throughout Australia, the lack of viable markets is a real concern. [There is a need to examine] what mechanisms can be utilised to create a market by, for example, breaking work down into smaller components. (Sub. 153, p. 19)

Where similar contracts are to be let, contracts could be let for varying periods with staggered commencement and completion dates to maintain competition between various operators. Additionally, agencies could encourage greater tender participation by distributing tender information to a wider range of potential contractors, enhancing the market’s knowledge of the opportunities available through government contracts.

However, as noted in section C4.2.1, competition may be enhanced by tendering larger contracts, suggesting that supplier capture may be less likely where larger contracts are tendered. Moreover, to the extent that competition is present in the initial tender, the agency may consider a longer contract to lock in the benefits of these competitive pressures.

This suggests that, to avoid supplier capture, encourage competition and minimise transactions costs, agencies should look first to aggregating service requirements into larger contracts.

The Commission notes participants’ concerns regarding predatory pricing by contractors. However, it has not received any substantive evidence of cases where this has adversely affected contracting outcomes (in terms of quality or cost).

Where a market is characterised as a natural monopoly, the important issue is whether any substantial barriers to entry — or sunk costs — limit market contestability. Where sunk costs are relatively low — indicating a high degree of market contestability — the threat of entry by alternative suppliers will induce the monopoly supplier to act efficiently. Conversely, where sunk costs are relatively high, incumbent contractors will have few incentives to operate efficiently.

It should be stressed that cases of pure natural monopoly are relatively rare. For many purported natural monopolies, closer inspection reveals relatively close substitutes or similar service providers. The extent to which many natural monopoly markets are characterised by limited contestability is also debatable. For instance, the extent to which sunk costs prevent the entry of potential competitors may be overstated where the physical transferability of assets is overlooked. For example, while a regional centre may require only one radiology clinic, the radiology equipment may be moved from one location to another. In such cases, the potential for supplier capture is reduced.

In those cases where sunk costs do shield the natural monopoly supplier from competitive pressures, it may be possible to separate the contestable elements from the non-contestable components. Competition can be introduced into the former market while the remaining monopoly market can be dealt with as appropriate.

One potential solution in this regard is to have an operating lease, sometimes referred to as a 'franchise'. The agency retains ownership of the assets because of their (non-contestable) natural monopoly characteristics, but introduces competition for the right to operate these assets. Applied to the earlier radiology example, the franchising option would see public ownership of the X-ray equipment maintained, with tenders seeking qualified operators to provide radiology services to the district.

On this approach, Skilled Engineering submitted that it:

... would consider that franchising is appropriate in those unique cases where the asset base is vast ..., the resource base is special ..., [or] the industry is strategically important. (Sub. 69, p. 19)

However, it is important to ensure that the contract incorporates appropriate asset maintenance incentives, identifies which party is liable in the event of a breakdown or negligence and includes provisions for asset replacement.

In cases of limited competition, emphasis should be placed on creating an environment conducive to potential competition (eg by distributing information to a wider range of potential contractors).

Recommendation C4.3

Where natural monopolies exist, agencies should separate the contestable from the non-contestable elements of the service, and consider using operating leases for those natural monopoly elements with significant sunk costs.

Discriminatory specification

Aside from broader questions of appropriate bundling of service requirements, it is important to ensure that service specifications are framed in such a way as to not unduly favour particular contractors. Where care is not taken, the potential exists for certain suppliers to be awarded contracts despite the existence of alternative service providers equally or more able to meet the agency's performance requirements, though using a different process.

These concerns are particularly relevant where existing internal service providers are permitted input into the specification of services prior to tender. For instance, if it is given the responsibility for framing service specifications, an in-house team may, knowingly or not, specify the service in such a way as to provide it with an operational advantage over potential competitors. Indeed, such problems may occur when any incumbent operator is given responsibility for the specification of service requirements.

One participant argued that the way tenders are written discriminates against it in the tender process. Agency Contracting Services, which provides labour requirements on a subcontract basis, expressed concern that many tenders require an employer–employee relationship, thus preventing it from bidding (Sub. 281).

The approach adopted by the City of Melbourne recognises the benefits of consultation, while incorporating safeguards against the potential for discriminatory specification:

The Client Manager is responsible for the drafting of the specifications, usually with some input from the existing service provider. However, the specification is drafted with the clear understanding that it is to be about the business the council requires in the future, and not necessarily based on business as currently [operated].

The service provider, ... while having some input into the specifications, cannot be sure that the service which will be specified in the tender documentation is that which they have been accustomed to delivering in the past. They are not provided access to the specification until it is formally released. (Sub. 89, p. 13)

The 'discriminatory' nature of specifications may also be reduced through the use of performance or outcome specifications rather than the process-oriented approach. This helps to ensure that particular suppliers are not unduly

advantaged or disadvantaged (and provides other benefits, as discussed in chapter C6). Indeed, the Independent Commission Against Corruption (ICAC) submitted that better specifications were those that:

... involve a specification of the outcome required rather than the means for achieving that outcome. This will ensure no one supplier is favoured in a tender specification. (Sub. 68, p. 2)

Agencies should seek to avoid contract specifications which discriminate against particular suppliers. This may be facilitated by consulting with a wider range of stakeholders than just the incumbent supplier and the use of performance or outcome specifications. (see section C6.2.1)

Incumbency advantages

Several participants suggested that existing suppliers — whether public or private — will possess a range of advantages over potential competitors. These advantages stem from the benefits of knowing the true costs of service provision, operational experience in supplying services to (or for) the agency and a demonstrated track record or reputation. For example, SACOSS suggested:

Incumbents clearly have many informational advantages as well as probable asset advantages over new bidders. (Sub. 58, p. 10)

Likewise, the Victorian Government noted:

An incumbent service provider has the advantage of knowing the client base in greater detail than the contracting body. (Sub. 215, p. 37)

Indeed, incumbency advantages will generally be more pronounced, the closer the working relationship between the purchaser and provider. This effect will be particularly prominent where emphasis is placed on the contractor's record for service delivery, relative to the unknown qualities of 'outsiders'.

However, in some cases incumbency advantages may be considered a reward for initially offering a good-enough deal to win the tender. A contractor may have provided services at a loss to gain access to a particular market and the associated advantages of incumbency. For example, the use of loss-leading pricing practices (see chapter C5) or occurrences of winner's curse¹ may lead to incumbents incurring losses meeting contractual requirements.

The Bureau of Meteorology submitted:

¹ Winner's curse refers to those contracts where the successful contractor underestimates the costs of providing the service and incurs a loss meeting agreed service provision requirements.

If an incumbent provider has established a good reliable service, they have gained an advantage, but this should not be considered an unfair advantage. Equally well, a provider may not have established a reliable service and may be disadvantaged through the contact (again, one could argue that this is not unfair). (Sub. 78, p. 11)

Nonetheless, it is important not to overstate the importance of incumbency advantages. They only become problematic where they lead to situations of undue restrictions on competition — for example, where the incumbent's advantage originates from asset ownership, preventing alternative suppliers from competing. Where the service being provided does not have unique qualities or require highly specialised knowledge, and alternative suppliers have had experience in providing a similar service elsewhere, the advantages of incumbency may be limited.

Indeed, DAS suggested that incumbency advantages are not as pervasive as some maintain:

It is likely that the incumbent suppliers will only have an advantage if they have maintained the highest standards of service and continually sought to improve through innovation. (Sub. 140, p. 66)

One possible counter to the advantages of incumbency is to furnish alternative suppliers with the same information that is available to the existing supplier. However, this should not extend to commercially sensitive information such as the costs of operating the service or other aspects of intellectual property.

Recommendation C4.4

Information about the service and contractual requirements should be provided to alternative suppliers when service provision is being retendered.

C4.3 The importance of confidence

The perceptions of potential bidders about the legitimacy of the competitive tendering process can affect the level of competition. Such perceptions may reflect past experience, known problems with the tender process or subjective assessments of impartiality. Where potential bidders are not confident in the probity or integrity of the tender process, their willingness to bid is likely to diminish.

Their confidence may be influenced by a range of considerations, including:

- the scope for collusive behaviour amongst tenderers;

- the impartiality and independence of the evaluation process;
- the transparency of the tender process; and
- the reputation of the contracting agency with regard to post-tender negotiations and contract management.

These points are also relevant to improving the accountability of the CTC process (see section B1.3).

C4.3.1 Probity in competitive tendering

The scope for collusive tendering

Collusion between bidders for a contract is likely to undermine significantly the benefits associated with competitive tendering. Collusion is an anti-competitive act whereby tenderers mutually agree to engage in certain practices to assure a favourable tender outcome. Practices such as quoting equal prices and discounts, the rotation of lowest tenderer² and contract sharing undermine competition by discouraging the participation of potential contractors and reduce cost savings through inflating tender prices.

Participants reported different experiences with collusion. The CCF suggested:

Within the construction industry the question of collusive tendering and corruption has in the past been of considerable concern. (Sub. 53, addendum 1, p. 4)

The ACTU commented:

Often markets are not competitive and contracting firms have significant market power, more specialised knowledge and expertise in contract negotiations. This can result in loss-leading behaviour, collusion by contractors and also in contractor capture ... (Transcript, pp. 1754-5)

In contrast, the Department of Defence, which has been heavily involved in contracting, reported no evidence of collusion in its Commercial Support Program (CSP) (Sub. 81).

Furthermore, DAS pointed out that, where collusion takes place, it contravenes the *Trade Practices Act* and that:

It is Commonwealth policy that any suspected instance of collusion be referred to the Trade Practices Commission [and now to its successor, the Australian Consumer and Competition Commission] for investigation. (Sub. 140, p. 45)

² This refers to the practice of contractors colluding to take it in turns to submit a low price winning bid.

Some participants were less convinced of the protection against collusion afforded by the *Trade Practices Act*, with Waggamba Shire Council (Vic) suggesting:

You can't do anything about collusion — it is extremely difficult to detect ... Corruption will always exist, the only question is how much the community is prepared to spend on minimising it. (Sub. 19, p. 9)

The Commission has not received any substantive evidence of collusive practices affecting tender processes and outcomes. Given that collusive practices affecting tender processes and outcomes are subject to the *Trade Practices Act* and may be acted on by other law enforcement agencies (such as the ICAC in New South Wales), the Commission has not made any recommendations in this area.

Impartial and independent evaluation

Even in those cases where service specification and the initial tender stages are free from undue discrimination, the evaluation of competing bids may be biased. Indeed, some participants suggested that evaluation mechanisms used to compare competing bids may sometimes be biased towards specific tenderers. A perception common to many participants was that in-house teams may be favoured in tender selection processes (whether through deliberate bias towards them on the part of the evaluation panel or other 'insider' advantages).

For example, the CCF, Queensland branch, raised concerns over the evaluation of external bids competing with Queensland Department of Transport in-house bids. The CCF suggested that the evaluation process was biased towards the in-house team for reasons other than the quality or price of the bid (Transcript, pp. 515-6). In its submission, the Queensland Department of Transport outlined the measures which are followed to ensure impartiality in the tender process. These include establishing guidelines which are agreed with representatives from the road transport industry, a requirement for prequalification of contractors who tender for work, and reviews and audits of cases where tenderers raise probity concerns (Sub. 207). The Department recently investigated claims of unfair competition (Sub. 207, p. 5) and now believes it has rectified previous problems.

A range of considerations relating to in-house participation in competitive tendering processes — including concerns that evaluation processes are biased towards in-house suppliers — are discussed in chapter C5.

One solution to these concerns may be the use of an independent representative on the evaluation panel. This representative, often called an independent auditor or 'white knight', helps ensure that competing bids are impartially evaluated and provides reassurance to participants as to the integrity of the evaluation process.

For example, the City of Melbourne referred to the use of independent auditors in its tender evaluation process:

... each Client Manager establishes a Tender Evaluation Committee which is required to include a financial analyst, an independent manager who has no involvement with the business being contracted, and an external expert in the business. ... This process ensures that the potential for one member to overly influence the views of other members of the Evaluation Team does not occur. (Sub. 89, p. 14)

The ACT Council of Social Service considered it desirable to include in the tender evaluation panel representatives from community organisations including those who represent consumer interests (Transcript, pp. 1212-13).

The Commission considers the appropriate approach — and one that is generally followed — is to appoint individuals with the relevant skills and expertise (including, where appropriate, experience of working on social and community issues) to the evaluation committee, rather than people representing particular interest groups.

External representatives may also be employed to vet the tender process more generally. For example, the Victorian Government has appointed an external probity auditor (Coopers and Lybrand) to provide guidance on the internal tendering process, assist in the development of probity guidelines and conduct probity audits of all New Prisons Projects evaluation processes (Sub. 215). Similarly, Stonnington City Council (Vic) noted that it:

... has engaged accounting firm Ernst and Young to undertake a probity audit of the competitive tendering process and a report on each service is presented to Council at the ... awarding [of] the contract. (Sub. 237, attachment C, p. 4)

Given the costs of external auditing, this option should be employed only in those cases where substantial concerns exist and the costs of these perceptions are likely to influence future tender processes. External audits would appear most relevant for large contracts or for those contracts where an in-house bid is involved.

Transparency of the tender process

A number of participants argued that it is important that a tender process not only be fair, but that it is perceived to be fair. To this end, it is crucial that the process be as transparent as possible. As the City of Port Phillip (Vic) commented:

Probity means not only ensuring that all stake-holders understand how decisions are made and how fair treatment is to be afforded to all, but also requires that we are seen to ensure that fair practice is maintained. This not only introduces a more understood process that can stand up to the rigour of inspection but also starts to develop a trust in the organisation. (Sub. 73, p. 8)

Indeed, the need for greater transparency was highlighted by a number of participants, including Boral Asphalt:

Transparency on tenders, particularly local governments is not always of a high quality. (Sub. 120, p. 15)

Spark and Cannon raised similar concerns about the lack of transparency in the tender process (Sub. 71, p. 9).

The most important determinant of transparency is the extent to which information on various aspects of the tender process is available to potential bidders, service users and other interested stakeholders. This matter is discussed in detail in chapter C6.

Transparency of the tender process is also important in terms of ensuring public sector accountability (see chapter B1).

C4.3.2 Agency reputation

Commitment to competitive tendering

The commitment of a contracting agency to completing a tendering exercise was a concern shared by many participants. Allegations were made that a number of agencies used tender processes to gain market and product information from the private sector — whether to benchmark internal providers or obtain new ideas in relation to service provision — with no intention of awarding a contract externally. Other agencies appeared to call tenders without sufficient forethought as to the service they required and how much they were prepared to pay.

For example, Serco Australia claimed:

For some reason NSW Government agencies seem frequently to call tenders for which they never declare a result. We rarely bid their tenders as a consequence. (Sub. 144, p. 4)

The Master Cleaners' Guild of Western Australia referred to a case where a member withdrew a tender:

... when the Guild showed there was no intention of actually letting the contract and it was really an information gathering exercise to provide benchmarks for the 'in-house' operation. (Sub. 80, p. 2)

Similar concerns were raised by the Association of Australian Aerospace Industries:

In some cases it appears that the CSP program is being used to benchmark the services against industry with no real intention of allowing the work to go out of the hands of

the [Defence] services. This has created enormous costs to industry in preparing bids which have had little chance of success. (Sub. 137, p. 3)

The Association suggested that the resultant industry cynicism towards the CSP was a problem that would persist in the short term, regardless of changes to CSP tender processes.

The number of participants expressing these concerns suggests that the issue of commitment to the competitive tendering process is having a real effect on competition and is an issue which many agencies need to address. Where agencies request information from external organisations, the costs of meeting these requests are invariably factored into tender prices, adding to the costs the community ultimately bears. Moreover, where industry cynicism leads to a reduced number of bidders, the level of competition — a primary driving force behind the benefits of competitive tendering — may be adversely affected.

Several participants considered that compensation should be paid to unsuccessful tenderers where an agency decides not to award a contract. Indeed, claims were made for the wider use of compensation payments to all unsuccessful tenderers, regardless of whether the contract proceeded or not. Such compensation would, in part, cover the costs of preparing a bid.

The Commission considers that the preferred solution is for an agency to improve its tendering habits. The option not to proceed to contract (as with any commercial decision) must always remain with the agency.

The Tasmanian Government commented, in response to the draft report, that as a general rule it does not support the proposition that firms be compensated for the costs associated with tendering in the situation where no tender is let (Sub. 288, p. 2). The Commission agrees with that general approach, but suggests that it may be appropriate for an agency to pay tenderers some compensation if there is a series of cases of tenders not proceeding to contract and the agency wishes to restore confidence in its commitment to competitive tendering. For example, where there is a lag between the introduction and 'industry' acceptance of these improvements (evidenced by the continued reluctance of external contractors to bid for certain public tenders), the use of compensation payments may be a cost-effective manner in which to restore confidence in the tendering process and reduce the costs of continued reductions in tender participation and competition.

Alternatively, compensation payments may be appropriate where contracting agencies announce voluntary changes to tender timetables or requirements which impose significant costs on tenderers. For example, the Commission's *Defence Procurement* report noted:

When Defence imposes a significant change on an announced project requirement or tender evaluation schedule which results in a retendering process, serious consideration should be given to reimbursing reasonable costs for the preparation of the new tender to bidders. Such situations probably arise only in major capital projects. (IC 1994b, p. 102)

Indeed, the Commission observed that Defence had already taken steps towards adopting these practices.

A further issue is the use of compensation payments as reimbursement for the use of the intellectual property or ideas contained in an otherwise unsuccessful bid. For example, an agency may decide to use a design concept from an unsuccessful bid by incorporating it in the final contract (whether awarded in-house or externally). Indeed, the Electrical Contractors' Association of Queensland submitted:

Private sector tenderers tell us they are less likely to tender if there is [an] 'in-house agency' competing. They are concerned that their innovation or idea will be pilfered by an agency either knowingly [or unwittingly] in full or in part ... (Sub. 182, p. 3)

The Commission notes that the application of compensation payments to this end may, in some cases, be appropriate.

Post-tender negotiations

Post-tender negotiations, and other actions which may change the nature of the contract after tenders have closed, may affect the confidence of external participants. Unsuccessful bidders may feel that they have been denied the opportunity to bid against the revised service requirements. This may lead to reductions in the level of tender participation and competition.

In the context of local government fleet purchasing, the ICAC noted the detrimental consequences that may result from affording preferences to local bidders. It was particularly concerned where these preferences extended to allow local bidders the right to better the 'best' bid (where this bid was from an outside organisation). ICAC suggested that such arrangements would discourage bidders from outside the 'local' area, implying that competition for service contracts may diminish. It also noted such arrangements may encourage corruption and collusion on the part of some bidders (ICAC 1993a).

However, there are occasions when post-tender negotiations may be beneficial. For example, post-tender negotiations may prove useful where the agency is able to modify an otherwise acceptable bid by removing certain qualifications or correcting for misunderstandings. Indeed, the South Australian Government (Sub. 123) considered that post-tender negotiations were essential to resolve and finalise all aspects of the agreement satisfactorily.

Contract management

If a contracting agency has a reputation for poor contract management or administration, it is likely that contractors will be less willing to tender for that agency's future contracts. For example, an agency may have a track record of excessive interference in a contractor's day-to-day operations, habitual late payment to contractors, raising costly disputes over minor contract technicalities and generally poor working relationships with previous contractors.

The Electrical Contractors' Association of Queensland referred to a case of a purpose-built switchboard installed under a government contract during construction of a government building, for which payment was delayed until the switchboard was deemed 'incorporated in the works'. Consequently, payment was not made until well after the switchboard was installed, essentially being delayed until other aspects of the project (that is, wiring the switchboard to a power source and other various outlets) were completed by the government agency (Transcript, pp. 553-4).

The Australian Chamber of Commerce and Industry noted:

It is apparent that many government agencies fail to understand the cash flow requirements of private contractors. They require projects and/or services to be completed by certain dates but then often have difficulty agreeing on whether the requirements have been met. Some firms have also experienced payment in a tardy fashion. (Sub. 202, p. 6)

The Commission agrees that the reputation of the contracting agency can play an important role in determining the level of competition in the tender process. Consequently, agencies should ensure that they address the perceptions of participants, and any problems relating to, for example, unfair business practices and late contractual payments. Better communication with tenderers, including debriefing of unsuccessful bidders, is discussed in chapter C6.

C4.4 Conclusion

Maintaining fair and open competition is central to securing the benefits potentially available from a competitive tendering process. Participants referred to a range of issues which may influence the level of competition for tendered service contracts.

The ability of various types of organisations (eg SMEs or specialist contractors) to participate in the tender process may be influenced by the size and scope of the tendered service. Likewise, the choice of contract length may have an impact on contract contestability. But agencies also need to consider these

issues in terms of the scope for strategic alliances, the costs of conducting the tender process and the potential for innovation in larger contracts.

Agencies should ensure that arrangements are in place to deal with markets characterised by limited competition and extreme cases of natural monopoly. The choice of contract specification and the possible use of franchising arrangements should be addressed.

The perceptions of external participants can play an important role in establishing an adequate level of competition. To this end, important influences on participants' perceptions include:

- the existence of an in-house bid;
- the reputation of the agency with respect to contract management and its commitment to competitive tendering;
- the use of post-tender negotiations to substantially change the nature of the contract or service requirements; and
- the overall transparency of the tender process.

Agencies should endeavour to address such concerns at source — for instance, by ensuring that appropriate costing mechanisms are applied to in-house bids (see chapter C5). However, additional measures may be required to address any remaining negative perceptions.

In this category, options such as an external audit of the in-house bid, independent representation on the tender evaluation panel or a probity audit of the tender process may be useful. These mechanisms are particularly important where the contract is relatively large or for a long period, where an in-house bid is present or where post-tender negotiations are more widely used.

C5 IN-HOUSE BIDS

C5.1 Introduction

Competitive tendering is a process designed to select the most efficient and cost-effective supplier of services. Within this framework some agencies allow in-house teams to tender for service contracts. An in-house bid refers to a situation where an internal team, often based on the existing internal provider, participates in the tender process and, if successful, supplies the required service on a 'contractual' basis. For some agencies, such as the Commonwealth Department of Administrative Services (DAS) and its state government counterparts, tendering to provide services to other agencies in the same jurisdiction as themselves, may also be considered to be in-house bids.

The concept of in-house bids raises a range of issues. This chapter discusses the approaches of different agencies and develops a framework for the consideration and treatment of in-house bids.

Agencies need first to consider whether in-house bids will be permitted, encouraged or mandated. Different jurisdictions and agencies have adopted differing approaches in this regard. The Department of Defence, for example, has agreed that in-house bids will be allowed where the jobs of civilian employees are involved. Conversely, the Western Australian Government approach is to discourage in-house bids for support activities where a competitive external market exists. In Victoria and Tasmania in-house bids are relatively infrequent and not encouraged. In contrast, the Queensland Government (Sub. 162) advised that the fundamental principles on which its Competitive Service Delivery process will be based are likely to include the right of in-house units to bid (see appendix B). And the South Australian Government said:

... the Government will, in general, support 'in-house' and/or management/employee buyout bids to compete against the private sector in most circumstances. However, this does not imply preference for in-house bids. (Sub. 123, p. 4)

The NSW Government also encourages in-house bids:

The benefits of market testing and contracting arise from competition and not necessarily from whether the private or public sector undertakes the function. In recognition of this and to ensure adequate protection for employees, the option of contracting to in-house service providers must be fully assessed and in-house providers

should be given every opportunity to compete on an equal footing with external contractors. (Sub. 294, p. 7)

Agencies need to consider the various benefits and costs associated with in-house bids. For example, in-house bids may provide benefits in terms of a deeper supplier market and human resource management, but they may impose costs in terms of additional probity requirements on the tender process. These factors are likely to vary significantly between agencies and services, and possibly over time.

Where in-house bids are permitted, a framework to address specific issues is required. In this category, participants have highlighted the importance of applying the tenets of competitive neutrality to differences in taxation and regulatory arrangements between in-house and external suppliers, and to appropriate costing mechanisms for in-house bids. Other conditions, including requirements for organisational separation and restrictions on some types of commercial behaviour, were raised as important considerations where in-house bids are permitted.

C5.1.1 The extent of in-house bids

While data on the extent of in-house bids is sparse, it appears that in-house tenders proceed only in a minority of competitive tendering and contracting (CTC) exercises. For example, as noted in chapter A2, less than 1 per cent of New South Wales Government tenders involved in-house bids in 1993-94. For local governments no data is available, though anecdotal evidence suggests that in-house bids are relatively more common than at the state level.

At the Commonwealth budget sector level, around 9 per cent of CTC exercises involved in-house bids in 1994-95, although there are substantial differences between agencies. At one extreme, in the Department of Defence in-house bids are not only common under the Commercial Support Program, but have won about one third of the activities competitively tendered so far.

Compared with the experiences of government agencies in the United Kingdom (the only other jurisdiction from which the Commission has been able to obtain data on this matter), Australian figures for in-house tender participation appear relatively low. For instance, UK data suggests that just under 40 per cent of CTC exercises include an in-house bid at central government level, while the majority (77 per cent) of contracts subject to compulsory competitive tendering in the local government sector were won by the in-house team in 1994 (see chapter A2). However, more recent evidence suggests a decline in the success rate of in-house teams at the local government level (Audit Commission 1995).

C5.2 The in-house option

C5.2.1 The potential benefits of in-house bids

There are many cases where the in-house team has shown itself to be the most suitable service provider. For example, the in-house cleaners at a New South Wales hospital were able to change work practices and submit a winning tender following the introduction of competitive tendering. The bid not only provided the hospital with an increased standard of quality but it was also the cheapest option (Domberger and Hall 1995). Moreover, the City of Melbourne (Sub. 89) referred to a study from the UK suggesting the cost savings from competitive tendering were double for those services where an in-house bid is allowed (see chapter B3).

This experience suggests that in-house bids may provide benefits in terms of access to a wider range of suppliers, or a deeper supplier market. By allowing in-house bids the agency ensures that it retains access to potential suppliers with experience in meeting the agency's specific service provision requirements (particularly in those cases where the service contracted is similar to that provided in the past). Allowing in-house bids may also be beneficial where the agency is unsure of the characteristics of the external market — providing access to 'known' suppliers with demonstrated experience.

Allowing in-house bids may assist in terms of improved outcomes for the management of the reform process overall and by providing a spur for further internal reform. In large part this stems from perceptions of the agency treating internal staff 'fairly' where in-house employees are given the opportunity to bid for their existing jobs. Moreover, perceptions of fair treatment may not be confined to those staff directly affected by the CTC process, but spread through the organisation more generally. For example, in response to the Commission's *Defence Procurement* report (1994b), the Commonwealth Government said, in part:

... the Defence experience with CSP has been that significant staff management and industrial relations issues are involved. The existence of an in-house option has been of substantial benefit in addressing these issues. (Ray 1995)

A number of private sector participants accepted a role for in-house bids. For example, Serco Australia's view was:

... the in-house team is perfectly acceptable as a participant in tenders. The issue is not who delivers the service, but rather the use of a competitive process to select the most cost effective service deliverer. (Sub. 144, p. 7)

C5.2.2 The potential costs of in-house bids

In-house bids may impose a number of costs on the contracting agency. These include the direct costs of preparing in-house bids and the potential costs of reduced competition where external suppliers consider in-house bids will be given preference or advantaged in some way.

Direct costs may include the costs of staff and management time (and external advice) devoted to the development of a response to the tender documentation. For large or complex service requirements, these costs may be substantial (see chapter C6). Similarly, costs may be incurred in terms of the savings forgone and the capital and training investments required to bring the in-house team to a standard comparable with that of external suppliers (see section C5.3.5).

Where in-house bids are perceived to have an unfair advantage over external competitors, indirect costs may be imposed in terms of reduced competition from external contractors. Perceptions of unfair competition may result from in-house teams having (or being perceived to have):

- access to internal information;
- the ability to influence service specifications in such a way as to favour the in-house team;
- a close relationship with those agency staff responsible for evaluating competing offers; or
- an advantage due to inappropriate costing of in-house bids, leading to concerns that in-house bid prices do not permit accurate comparisons of the relative costs of in-house and external tenders.

Boral Asphalt (Sub. 120) also noted that, where the sanction of bankruptcy was muted by implicit or explicit government guarantees, the incentives facing government businesses to operate efficiently and pursue sound investment and pricing strategies were diminished.

In Queensland, the Commission heard that, for some activities, the Queensland Department of Transport's in-house teams managed to win two out of every three of their tenders, outperforming external contractors who typically would manage to win one in eight. The Civil Contractors Federation (CCF), Queensland branch, suggested this difference could be attributed to inaccurate

costing of in-house bids and biased evaluation processes.¹ The Federation argued:

The continuation of this bidding policy will, and in some areas has already led to the withdrawal of private enterprise from the tendering process with the resulting loss of competition ... (Sub. 95, p. 5)

Some public sector agencies themselves recognised problems inherent with in-house bids. For instance, the Australian Bureau of Statistics noted that it:

... is wary of putting up in-house bids as they are regarded with some suspicion by the [information technology] IT industry — some vendors have indicated that they prefer not to enter into competition against in-house bids. (Sub. 111, attachment B, p. 1)

In many cases, these problems can be addressed directly; however, it is important to recognise that such actions may impose additional costs on the agency, not present (to the same extent) where in-house bids do not proceed. For instance, private sector concerns regarding the integrity of some Victorian local government tendering practices have induced the Office of Local Government to conduct spot audits of a number of local government contracts. The audits will be conducted principally where council workers win internal bids or tenders outside their municipalities (Hallam 1995). These spot audits effectively represent an additional cost of permitting in-house bids.

Additional costs may also result from a need to distribute more information to alleviate perceptions of unfair practices and through the organisational separation of in-house bid teams from the purchasing arm of the agency (see section C5.3.2).

C5.2.3 Weighing up the benefits and costs

In-house bids may provide contracting agencies with significant benefits, in some cases outweighing the costs associated with allowing in-house tenders. This suggests that agencies should not rule out the in-house bid option without considering the specific circumstances of each case. Furthermore, the likelihood of success of an in-house bid may vary markedly within and between agencies, depending on the type of service and the competitive position of the agency.

It seems likely that the costs and benefits will change over time, and this may influence the net benefits provided by an in-house bid. For example, as an agency's understanding of the external market grows, the benefits provided by

¹ The Queensland Department of Transport has completed an investigation of claims of unfair competition and an audit of the costing and selection procedures. The Department has implemented a program for reform aimed at reducing the scope for these types of problems.

access to known suppliers (in-house teams) may decline. Conversely, perceptions of external suppliers regarding the integrity of the competitive tendering process, even where in-house bids are present, are likely to improve over time, subsequently reducing the costs of allowing in-house bids.

In response to the draft report, participants expressed a range of views on whether and when in-house bids should be allowed. For example, the Royal Institute of Public Administration of Australia preferred in-house bids to be the normal procedure, and to be disallowed only when special circumstances prevail (Sub. 251, p. 7).

The Department of Defence said that the current practice of allowing in-house bids as the norm is based on both human resources and financial considerations (Sub. 285, Annex A, p. 1). However, it considered that in-house bids are more likely to be competitive in the more highly skilled areas of technical support and maintenance and be less competitive in lower skilled activities such as security, grounds maintenance and hospitality (Sub. 298, p. 1). The Department added that, in all but one case, the in-house bid provided strong competition for other bidders.

A number of participants suggested that in-house teams should be prevented from competing for service contracts. For instance, the Australian Electrical and Electronic Manufacturers' Association argued that "where it is decided an activity can be open to competition from the private sector for delivery, there be no in-house bid" (Sub. 28, p. 5) and the Australian Information Industry Association opposed in-house bids altogether (Sub. 287, p. 3).

In its report on *Defence Procurement* (IC 1994b), the Commission expressed the view that in-house bids should be allowed in principle, but went on to recommend that the Department of Defence consider the option of not proceeding with in-house bids where the costs of bid preparation are high and the probability of success relatively low.

Recommendation C5.1

Agencies should consider the option of an in-house bid when an activity is competitively tendered. The decision whether to allow an in-house bid should be taken after weighing the costs and benefits in each case.

In line with this case-by-case analysis of benefits and costs, consideration should be given to options which capture the benefits of in-house bids without

the associated disadvantages. For instance, some form of management/staff buy-out (MBO) may provide an avenue for ‘in-house’ teams to tender for service contracts, without some of the problems associated with internal bids.² A number of state governments provide for management/staff buy-outs (see appendix B). Alternatively, existing staff may transfer to external contractors — bringing with them the benefits of experience and knowledge of the agency’s service requirements (see chapter C8).

Similarly, in terms of assisting the agency to manage the reform process, the benefits provided by in-house bids may be achieved through other mechanisms. For example, improvements in redeployment, retraining or redundancy entitlements may provide similar ‘fair’ treatment outcomes for staff affected by competitive tendering.

C5.3 A framework for in-house bids

C5.3.1 The concept of competitive neutrality

For many services, the participation of an in-house provider in the tender process is workable, provided governments address a range of concerns to ensure that external suppliers have confidence in the equality of treatment afforded by the competitive tendering process.

To this end, the concept of competitive neutrality provides an appropriate benchmark as to how competing bids should be compared. Competitive neutrality refers to those administrative and legal arrangements which treat all organisations and individuals in an equivalent manner. This includes public, private and not-for-profit service providers.

² The MBO option will still require a number of probity measures (eg external costing audits or independent evaluation) in common with in-house bids. Indeed, these types of measures are suggested by the Victorian Government’s guidelines on contracting out by agencies using the MBO approach (Victorian Office of State Owned Enterprises 1994). Additionally, costs may be incurred in evaluating the risks associated with contracting to an MBO organisation with demonstrated experience in service delivery, but limited knowledge of business planning, cash flow management, marketing or human resource management.

The National Competition Policy Report (commonly called the Hilmer report) developed a range of policy principles aimed at assisting governments to formulate a consistent approach to competition policy issues. With reference to competitive neutrality, the report recommended that “government businesses should not enjoy any net competitive advantage by virtue of their ownership when competing with other businesses” (Hilmer et al 1993, p. 308). Indeed, the report noted:

... reforms intended to promote the contracting out of services traditionally supplied by an in-house monopoly provider may be thwarted or undermined if the in-house producer’s advantages serve to limit the emergence of effective competition. (p. 297)

Following the Hilmer report, a number of inter-governmental agreements between the Commonwealth, States and Territories have been reached. These agreements bind the parties to a range of policy principles, including those relating to competitive neutrality set out in the Competition Principles Agreement (see box C5.1). Under this Agreement, the parties have agreed to formulate policy statements on competitive neutrality by June 1996, including the application of competitive neutrality provisions to local government.

Box C5.1: The Competition Principles Agreement

The Competition Principles Agreement between the Commonwealth and all Australian States and Territories outlines the responsibilities of these parties to establish competitive neutrality between government businesses and private sector competitors. The Agreement notes:

The objective of competitive neutrality policy is the elimination of resource allocation distortions arising out of the public ownership of entities engaged in significant business activities: government businesses should not enjoy any net competitive advantage simply as a result of their public sector ownership. (p. 5)

The Agreement makes a distinction between government business enterprises (classified as Public Trading Enterprises or Public Financial Enterprises under the Government Financial Statistics Classification) and other ‘significant business activities’ undertaken by agencies as part of a broader range of functions.

For the former, the parties agreed, where appropriate, to adopt a corporatisation approach for government business enterprises. They also agreed to impose full Commonwealth, State and Territory taxes (or equivalents), debt guarantee fees and the imposition of a regulatory environment equivalent to that faced by private sector businesses. For other significant business activities, the Agreement suggests that similar principles should be applied, or agencies should ensure that prices charged for goods and services will take account of these principles and reflect the full costs of service delivery.

Source: COAG (Council of Australian Governments) 1995b (Competition Principles Agreement)

Legislation has been passed (*Competition Policy Reform Act 1995*) enacting other recommendations of the Hilmer report, including the extension of the *Trade Practices Act* to government businesses and unincorporated enterprises.

The concept of competitive neutrality does not require that all firms compete on a completely equal basis. Indeed, differences in size, asset base, staff and management skills and experience may influence the relative competitive advantages and disadvantages of competing firms.

However, where organisations are competing in the same market, competitive advantages may arise through the imposition of different regulatory or other requirements. Governments and their agencies operate in environments which may confer on them a number of advantages and disadvantages relative to external suppliers of services. Box C5.2 lists a range of potential advantages and disadvantages arising from public ownership.

A number of participants submitted that, in practice, these characteristics combined provided a net competitive advantage to in-house bidders. Predominantly, participants suggested that public sector bidders were advantaged by exemptions from a range of taxes, particularly input taxes. For instance, the Queensland Historians' Institute noted:

... in Queensland, professional historians tendering for history commissions compete against State Government agencies, in particular, the History Research Service of the State Library of Queensland. ... the History Research Service has a substantial advantage in tendering as the Queensland Library being a government agency is exempted from Sales Tax. It also has advantages in access to capital equipment and research materials over professional historians working in private practice. (Sub. 169, p. 2)

The CCF, Western Australian branch, submitted:

... [in-house] tender submissions should be required to include appropriate pricing arrangements relative to taxes, dividends, debts for service charges, corporate overhead charges and so on. (Sub. 77, p. 3)

Some participants argued that the combined effect of all these factors was a net disadvantage to in-house providers. For example, Brisbane City Council noted its in-house suppliers received advantages in terms of free office rent, below cost use of storage yards and exemptions from sales tax. However, the Council considered that advantages accruing to the in-house team are offset by the negative effects of restrictive award conditions, lost productivity in Council-specific meetings and corporate overheads (Sub. 121).

Box C5.2: Potential advantages and disadvantages affecting public sector agencies

Government agencies and departments may enjoy a range of potential advantages, and experience a number of potential disadvantages, by virtue of their public ownership. The following list is intended to document, from submissions the Commission has received, the range of potential advantages and disadvantages that may apply. This does not imply that these characteristics pertain to all public agencies.

Potential advantages

- Exemptions from Commonwealth taxes (including company tax, sales tax, financial institutions duty, import duties, fringe benefits tax, fuel excises)
- Exemptions from State and local taxes (including property rates and taxes, land tax, debit tax, franchise and licence fees, payroll tax)
- No requirement to return a profit, rate of return on investments or account for depreciation expenses
- Tied clientele and the opportunity to cross-subsidise commercial operations from monopoly markets
- Immunity from bankruptcy and the threat of takeover
- Exemptions from various Commonwealth and State legislation (eg the competition policy provisions of the *Trade Practices Act*)
- Access to various corporate overheads free of charge (or at reduced rates), including office accommodation, payroll services, human resource services, marketing and IT services
- Cash flow advantages through budget arrangements which give agencies access to funds at the start of the financial year
- Cheaper capital financing (no risk premium where the agency is backed by an explicit or implicit government guarantee)
- Preferential input to tender specifications

Potential disadvantages

- Difficulty in accessing taxation benefits of depreciation, investment allowances and other deductions (eg through the transfer of taxation losses)
- Public sector award conditions and higher public sector superannuation contributions
- Lower degree of managerial autonomy, for example due to the requirement to comply with Ministerial directives
- Greater accountability costs given the public sector's reporting and regulatory requirements
- Lack of flexibility in reducing or restructuring corporate overheads
- Constitutional and legal constraints, including being subject to Administrative Law
- Lack of direct access to capital markets

Source: Joint Committee of Public Accounts 1995a; Spark and Cannon, Sub. 71 and DAS, Sub. 140.

Similarly, DAS suggested that, when taking into account the full range of advantages and disadvantages pertaining to government ownership, the net effect could be that government agencies were worse off than private sector competitors.

The Commission has examined competitive neutrality between in-house and external tenderers, with particular consideration given to taxation and regulatory differences between some public and private organisations and to appropriate costing of in-house bids. These issues are discussed in the context of introducing an effective form of organisational separation (see section C5.3.2) and through other competitive neutrality measures (see section C5.3.3).

C5.3.2 Addressing competitive neutrality concerns

Organisational separation and competitive neutrality

To ensure competitive neutrality between the in-house team and external providers, not only must the tender process be fair, but the obligations of a winning in-house team to deliver the agreed service at the agreed cost must be comparable to those conditions that would apply to an external provider.

A number of participants highlighted the potential problems that may occur where the in-house team is not adequately separated from the contracting agency. For instance, the Electrical Contractors' Association of Queensland submitted:

... in order to compete [in-house providers] endeavour to use their once quasi-regulatory role to continue to control the industry in their favour, through application of their interpretation of Regulatory and Statutory requirements. (Sub. 182, p. 2)

The CCF considered:

... in many cases 'in-house bids' are assessed by people not independent from those preparing the bid. (Sub. 53, p. 3)

Similarly, the Master Cleaners Guild of Western Australia noted a case where an agency:

... justified taking an existing 'contracted out' contract back 'in-house' by changing the specification after tenders closed to suit an 'in-house' arrangement. (Sub. 80, p. 2)

Many saw a need for physical and informational barriers between the bid team and those responsible for purchasing services. These barriers aim to place the in-house tenderer in a position equivalent to external contractors in terms of access to information and influence over the tender evaluation process and contract management. For example, the Tasmanian Government suggested:

The mechanisms or processes used by in-house tendering should be the same as those used for external tenders. In-house providers and tender managers should be separated within the organisation through a combination of physical separation of the work groups and the creation of an independent contracts assessment team within the existing organisational structure. (Sub. 108, p. 30)

The introduction of an effective form of organisational separation is central to the maintenance of confidence in the legitimacy of in-house bids. This will be achieved by:

- separating the in-house team from all aspects of service regulation and specification, tender evaluation and contract management;
- introducing a degree of commercial autonomy, including the discipline of a requirement to cover costs and return an appropriate profit; and
- ensuring a transparent relationship between the in-house provider and the contracting agency.

Recommendation C5.2

Where there is to be an in-house bid, it should be prepared by an organisational unit which is separate from all aspects of service regulation and specification, and tender evaluation.

The appropriate form of organisational separation

The organisational structure of various government business activities has been a key component of recent public sector reforms. Predominantly, the reforms have been aimed at placing these operations on a more commercial footing, employing variations of the corporatisation and commercialisation approaches.

Corporatisation versus commercialisation

Corporatisation aims to convert a public enterprise into an organisation which is as similar in terms of its objectives, incentives and sanctions to a private firm, as is feasible, while retaining public ownership. Under corporatisation, the in-house team becomes a distinct entity, legally separated from the parent agency. Other features of a corporatised organisation should include, amongst other things, clear commercial objectives, managerial autonomy in day-to-day operations, a requirement to earn a commercial rate of return on assets, clear and separate funding of any community service obligations, and being subject to taxes and regulatory requirements that would apply if the same activities were

carried out in the private sector.³ Importantly, corporatisation removes virtually all of the advantages and disadvantages that accrue to a public service provider by virtue of its ownership, thereby enhancing competitive neutrality.

The corporatisation approach has been used by the City of Melbourne. It has transferred several successful in-house bidders to a council-owned company, Citywide Service Solutions Pty Ltd.

The Hobart City Council considered that with CTC, corporatisation is the best method of organisational separation:

The most practical solution appears to be the imposition of a requirement that internal service providers be located within a corporate structure, physically and legally separate from the parent authority. (Sub. 153, p. 21)

Another option is for public agencies to ‘commercialise’ their in-house suppliers. Commercialisation, although variously defined, generally involves a government directive to a public agency or authority to conduct all or some of its operations, as far as possible, on a commercial basis.⁴ This may include the freedom to purchase inputs from any source and freedom to price outputs on a more commercial basis, together with requirements to be financially viable and demonstrate this through the production of separate commercial accounts. This could be achieved, for instance, through the establishment of a commercially autonomous unit within an agency.⁵

Commercialisation, in varying degrees, is employed by a range of government agencies. For example, DAS’s fourteen business units operate under a commercialisation framework. Likewise, Brisbane City Council submitted that its in-house bids for water and sewerage contracts are managed by a separate business unit Pipelines Contracting (Sub. 121). Similarly, in New South Wales,

³ The term ‘corporatisation’ is sometimes used to refer solely to the act of creating a separate legal entity. This is not the context in which the term is used in this chapter. The Commission has examined various aspects of corporatisation in its Annual Report for 1991-92 (IC 1992) and in several of its inquiry reports in recent years, including Port Authority Services and Activities (IC 1993), and Urban Transport (IC 1994a). It drew that experience together in an Information Paper “Improving the Efficiency of GBEs” in May 1994 (IC 1994d).

⁴ In a general sense, the term ‘commercialisation’ could refer to any move which is aimed at placing the agency’s activities on a more commercial footing. However, most agencies understand the term to specifically exclude the creation of a separate legal entity, and this is the sense in which it is used in this report.

⁵ The Commonwealth Department of Finance is currently developing a revised policy framework and practical guidelines for Commonwealth agencies engaging in commercialisation, in line with the recommendation of the Joint Committee of Public Accounts (Department of Finance 1995a, p. 1).

Bankstown City Council has established eight business units to deliver services to council (Sub. 247, Attachment, pp. 13-14).

The Hilmer report examined the relationship between organisational structure and competitive neutrality. The report suggested that competitive neutrality is most likely to be achieved where government service providers operate under the corporatisation approach, particularly where the service is provided to the public. Where the public agency has traditionally supplied other government agencies, the report suggested that alternative measures such as commercialisation may be appropriate, where corporatisation is not practicable (Hilmer et al 1993).

Some form of commercialisation may be a more appropriate approach where the additional benefits provided by corporatisation, including enhanced transparency and improved external confidence in terms of competitive neutrality, do not warrant the extra costs it imposes on agencies. These costs may include the administrative expenses involved in the move to corporatisation, as well as any additional costs of operating within a corporatised environment. This is likely to be so particularly for small activities.

In this context, while the City of Melbourne has transferred several successful in-house bidders to a council-owned company, activities that the Council considered too small for its trading company are conducted by 'service units' which operate on the basis of full cost recovery (Sub. 89, pp. 11-12).

Similarly, while the Department of Defence gave in principle support to creating separate legal entities such as Australian Defence Industries, it did not find that an appropriate option for smaller scale activities, including the bulk of CTC possibilities (Sub. 285, p. 2). In response to the suggestion by a Commissioner at the public hearings of creating a separate legal entity to manage a range of in-house operations, such as successful in-house bids under the Commercial Support Program, Defence noted:

To aggregate in some sort of centralised way, under a holding company ... I'm not sure it would result in an efficient or an effective outcome. (Transcript, p. 1089)

Some other participants, including the Local Government and Shires Association of NSW (Sub. 290, p. 11) and the ACT Government (Sub. 266, p. 13) considered that the costs of creating a separate legal entity, particularly in the case of small in-house contracts, could be too large. However, the CCF was of the view that these costs are not a major factor (Sub. 252, p. 6).

DAS argued:

Whether or not corporatisation represents the most effective means of achieving competitive neutrality depends on a variety of factors. ... regard needs to be had to the nature of the service and its competitors. (Sub. 300, p. 3)

Several governments expressed the view that it is not possible to predetermine which approach for achieving competitive neutrality is preferable. For example, the South Australian Government said that its preferred approach is to assess the relative merits of applying corporatisation or some other options on a case-by-case basis (Sub. 272, p. 6). The NSW Premier's Department argued that corporatisation is not appropriate in many cases covered by its market testing policies (Sub. 294, p. 5). The Queensland Treasury considered that it is possible to achieve an adequate degree of separation between an in-house service provider and other parts of the organisation without creating a separate entity (Sub. 277, p. 1).

The Commission recognises that in some cases the costs of corporatisation may outweigh the benefits, and it may be sensible to retain the in-house team as an integrated part of the agency. However, this approach is likely to apply only in a limited number of cases, primarily where the contracts in total are of relatively low value. Under this approach, particular emphasis should be given to ensuring competitive neutrality is achieved, with mandatory requirements for separate commercial accounts.

Recommendation C5.3

Where an in-house team wins a tender, it should be managed, at the very least, as a commercially autonomous unit, with its own set of commercial accounts and formally separated from all aspects of contract management. Monitoring and reporting arrangements should be established to ensure that the agreed price and performance standards are achieved. However, the Commission recognises that some governments and agencies will wish to go further than this minimal position and corporatise the in-house unit.

Pricing decisions

The freedom to pursue some 'commercial' practices may also be an important consideration in the choice of appropriate organisational structure. Indeed, several participants referred to private sector 'loss-leading' and pricing for excess capacity, suggesting that these activities need to be considered in the

context of government suppliers tendering for service contracts. Similarly, attention was focussed on the scope for in-house teams to compete in external or non-traditional markets.

‘Loss-leading’ behaviour refers to the situation where an organisation may price a bid below short-run marginal costs in an attempt to gain or retain access to a market. It is expected that losses will be later recouped through the benefits of experience, reputation and, perhaps, information advantages obtained over the period of the contract. As such, pricing decisions leading to short-run losses can be seen as rational where costs are covered in the long term.

Similarly, pricing decisions may also take into account any short-run spare capacity available to the organisation. In this case, a rational pricing decision may only cover the short-run marginal costs of operation in the aim of employing otherwise idle assets.

DAS noted that its business units adopted a range of pricing strategies similar to those employed by private sector suppliers:

The pricing policy adopted by the DAS businesses is very similar to that adopted by their private sector counterparts. Pricing is essentially market driven such that the price is based on what is required to win the work in the market place. At times this price may be below full costs, it may be marginal pricing or it may be at a price well above full costs. ... However, just as private sector competitors are required to adopt a pricing policy that ensures financial viability in the long term, so are the DAS businesses. (Sub. 140, p. 34)

Clearly, competitive neutrality implies that in-house teams should be able to adopt practices similar to those available to their competitors. However, the argument that public sector agencies should be able to adopt commercial pricing practices equivalent to those of private sector suppliers needs to be considered in the context of the environment in which agencies operate.

Without appropriate incentives, the potential exists for in-house teams to apply ‘commercial’ pricing practices in a way, or for a period of time, which a private sector competitor would find unsustainable. For example, financial incentives and bonuses, employment security and possibly the personal assets of private sector managers may be jeopardised by a poor pricing decision, leading to (long-term) losses. Corresponding incentives for public sector managers of commercialised suppliers may not be equally strong. Indeed, the Joint Committee of Public Accounts noted, in reference to DAS business units:

... the Committee accepts ... that loss-leading on bids for particular projects can be a legitimate business practice. Nevertheless, in the absence of full market disciplines on government businesses, it is important that government businesses not act in a way to corrupt or distort the competition to which they are exposed. The Committee believes that if any government business is exposed to particular and, on face value, plausible

criticisms, the matter should be referred to the [Prices Surveillance Authority] for examination. (Joint Committee of Public Accounts 1995a, p. 215)

Private sector managers must also ensure that pricing practices do not contravene the competitive conduct provisions of the *Trade Practices Act 1974* (TPA). The TPA provides some check on loss-leading pricing being used as predatory pricing (where below-cost pricing is used to drive potential competitors out of business, resulting in a substantial lessening of competition). Reforms introduced through the *Competition Policy Reform Act 1995* extend the application of the TPA competitive conduct rules to government business enterprises and unincorporated organisations.

However, the Commission notes that the application of these provisions may not encompass all ‘contracting’ within government. For example, where two departments from the same jurisdiction enter into a service agreement, the provisions of the TPA do not apply as they legally represent the same party. Yet, to the extent that ‘transactions’ involving other parties (including external suppliers) are associated with any service agreement between or within government agencies, the provisions of the TPA may apply to these ‘internal transactions’.

Bidding for outside work

The incentive structure provided by commercialisation may also present problems where in-house teams are permitted to tender for external or ‘non-traditional’ contracts.

For local governments in Victoria, the compulsory competitive tendering legislation encourages councils to bid for work in neighbouring shires. And the Municipal Association of Victoria had its sights on other levels of government:

Local government councils could provide services traditionally undertaken by State government authorities and public utilities, for example, the management and maintenance of railway stations, selected Roads Corporation roads and cooperative public housing developments. (Sub. 302, p. 5)

In a similar vein, the Commission heard that the Queensland Department of Transport has been active in seeking local government road construction contracts, previously the domain of private sector construction companies. And Waggamba Shire Council tendered for Queensland Department of Transport contracts (Sub. 262, p. 2). In New South Wales, Bankstown City Council’s business units also compete externally for work (Sub. 247, Attachment, p. 13).

Some government agencies, including DAS and its state government equivalents, have traditionally been involved in supplying services to other government departments and agencies within their own jurisdiction. In response

to the introduction of competition into previously tied markets (those markets where government agencies were required to obtain services from a designated government supplier), some of these agencies have sought work from outside their traditional markets, including contracts with other levels of government or with private sector organisations.

A number of participants questioned the legitimacy of government agencies actively seeking work in ‘non-traditional’ or new markets. Some suggested that a range of problems — including those present where private/not-for-profit operators attempt to compete with in-house teams — meant that government suppliers were able to compete unfairly in these markets.

During the public hearings, the Commission was informed that prison laundries operated by the Queensland Corrective Services Commission are able to compete for outside laundry contracts, particularly from the State’s hospital sector. It was suggested that such actions constitute unfair competition given the range of benefits accessible to the prison laundry operations, including sales tax-exempt laundry equipment, the ability to pay below award rates to inmates and below-cost access to necessary overheads (Transcript, pp. 571-2). Indeed, some state governments, including Western Australia and South Australia, prohibit in-house teams from competing in private sector markets (see appendix B).

Where a government agency bids for an external contract, it may increase its exposure to a number of risks (in excess of those risks associated with supplying services directly to, or for, the agency). For example, in the late 1980s the Shire of Bombala in New South Wales successfully bid for a Roads and Traffic Authority contract for a road deviation in the neighbouring Eurobodalla Shire. However, the Shire of Bombala underestimated the costs of constructing the deviation and incurred a significant loss. As the Shire did not insure against this contingency, the shortfall was ultimately made good from other council revenue, meaning that the Shire’s residents effectively paid for the loss either through higher rates or lower levels or quality of service provision (Rimmer 1993).

The Hilmer report considered that the extension of government business activities into non-traditional or new markets raised the potential for unfair competition (where competitive advantages of government had not been addressed) to corrupt these markets and for agencies to take business away from more efficient suppliers. To address these concerns, the report recommended that agencies should not be allowed to compete for business outside traditional markets unless competitive neutrality considerations were addressed. It highlighted the role that an effective form of organisational separation,

preferably corporatisation, could play in addressing competitive neutrality concerns (Hilmer et al 1993, pp. 308-9).

The Commission's view

Concerns over the effectiveness of the incentive structure facing public sector managers points to a greater role for corporatisation. Indeed, where agencies wish to pursue commercial pricing strategies or compete for contracts in external or non-traditional markets, the importance of an adequate incentive structure in ensuring competitive neutrality suggests that the corporatisation approach is appropriate. Where agencies wish to engage in these types of commercial behaviour without the discipline of corporatisation, they should be required, under the competitive neutrality policy statements (see box C5.1), to demonstrate the effectiveness of alternative competitive neutrality measures.

Recommendation C5.4

Corporatisation is the preferred approach to achieving competitive neutrality, but may not be appropriate in all cases. The circumstances when commercialisation may be an acceptable substitute should be examined further. This examination should consider wider issues of the role for corporatisation in public sector reform, whether and what restrictions should be imposed on the trading activities of business units when corporatisation is not considered appropriate, the appropriate form of corporatisation and implementation processes. This task could usefully be taken up by the Council of Australian Governments.

C5.3.3 Competitive neutrality without corporatisation

Where in-house teams operate under a corporatisation framework, issues of competitive neutrality are largely resolved. However, as noted above, there may be cases where a corporatisation approach is not appropriate. In these cases, alternative measures to promote competitive neutrality, ensuring recognition of the full economic costs of resources used by government businesses, are required.

Competitive neutrality may be achieved where agencies employ a system of 'pricing directions', whereby competitive advantages are removed through requirements for government businesses in preparing in-house bids to account for the implicit costs a similar private organisation would incur (such as taxes, commercial accommodation and input costs and a profit component). The

Hilmer report noted that adjusting bids is essentially an accounting approach and is:

... likely to be less effective in addressing competitive neutrality concerns than corporatisation where competitive advantages and disadvantages are removed. However, they may be acceptable if corporatisation is not practicable ... [and the] directions are strictly enforced. (Hilmer et al 1993, p. 302)

Alternatively, competitive neutrality may be progressed where specific advantages and disadvantages are removed. For example, exemptions from the competitive conduct rules of the TPA may be removed or arrangements for in-house teams to pay commercial costs of capital may be introduced to remove the competitive advantage these factors provide. Given that these measures are more effective at addressing competitive neutrality concerns, the Commission favours their use over alternatives such as pricing directions.

However, to the extent that these reforms are implemented individually, there may be cases where factors providing a competitive advantage are removed without corresponding disadvantages being addressed, potentially leading to in-house teams receiving a temporary net competitive disadvantage.

The Commission recognises that this point may be of concern to some agencies. However, it needs to be weighed against the importance of continuing moves towards competitive neutrality. Indeed, pressures to address disadvantages affecting in-house teams may only surface where artificial advantages, such as access to cheaper capital, are removed. This does not diminish the emphasis that governments should place on ensuring that remaining disadvantages facing in-house suppliers are addressed.

Some of the issues relevant to the competitiveness of in-house providers are being considered by governments in the context of preparing policy statements on competitive neutrality (see box C5.1).

Offsetting differences in taxation treatment

Taxation persists as one area in which some government-owned entities may receive a systematic advantage in comparison with private sector competitors. It was also one of the primary issues raised by those participants concerned with competitive neutrality of in-house bids.

These advantages may be addressed by subjecting in-house service providers to a range of 'taxes' (or tax equivalent payments⁶) or by adjusting in-house bids to

⁶ Agreement has been reached between the Commonwealth, States and Territories to impose tax equivalent payments, broadly matching Commonwealth tax legislation, on their wholly

account for the relevant tax liabilities. As noted above, the Commission favours the use of tax equivalent payments (or actual tax payments) as a means of addressing differences in taxation treatment.

A range of 'input' taxes and charges may substantially affect competitive neutrality. This occurs as exemptions from these taxes may induce an enterprise to act differently given that the input prices faced by the organisation will be different than if taxes were paid. Included in this category are payroll tax, wholesale sales tax and excise duties, stamp duties, financial institutions duties, land taxes, licence fees and local government rates and charges. All of these taxes and charges apply to inputs and can be shown to be non-neutral in their application.

Arthur Andersen (1995) has prepared a report for the Victorian Office of Local Government on the effect of taxation on the competitive neutrality of local government under compulsory competitive tendering. The report found that the taxes which have the greatest impact on local governments are likely to be wholesale sales tax and State payroll tax.

A number of agencies are already subject to some or all of these taxes and charges, or to taxation equivalence regimes. However, these requirements are primarily directed towards government trading enterprises, as opposed to individual business units within agencies or other 'non-trading' organisations. To the Civil Contractors Federation this was an advantage of corporatisation:

... if all in-house suppliers are corporatised the issue of what taxes and charges are relevant disappears and these in-house suppliers can then compete on the same level as other tenders. (Sub. 252, p. 6)

In other cases, some tax payments may be included indirectly in an in-house bid. For example, where an agency leases office accommodation at commercial rates, the lease payments will generally include a payment towards the lessor's land tax liabilities. Likewise, where a costing system allocates a commercial value to the accommodation occupied by the in-house team (regardless of whether an equivalent rent is paid by the agency), this generally will include a component for imputed land tax liabilities.

It has been argued that the removal of the exemption of government agencies from Commonwealth income tax is, in theory, not required to satisfy the tenets of competitive neutrality between government and external suppliers. A discussion of these issues is contained in the Commission's report into *Charitable Organisations in Australia* (IC 1995d) with reference to the tax

owned trading enterprises by 1997. A joint Commonwealth-State Taxation Equivalent Regime standing committee is working towards furthering these proposals.

exemptions afforded charitable organisations. In this report, the Commission noted that:

Overall, the income tax exemption does not appear to represent a critical advantage to [tax-exempt Community and Social Welfare Organisations] over for-profit competitors. (p. 313)

In the context of the Commission's current inquiry, tax equivalent payments may assist in creating a more commercial and distinct relationship between an in-house supplier and its government parent, particularly in terms of making the revenue transfer between the in-house team and the government more transparent. The interaction between income tax exemptions and competitive neutrality should be examined by governments in the context of developing policy statements on competitive neutrality.

Recommendation C5.5

In-house suppliers should be made effectively liable for all relevant taxes and charges, with payments made, where practicable, to a central revenue body.

However, the implementation of a similar system for local governments may be problematic, given the lack of a revenue body equivalent to a state or territory treasury. The Commission recognises that such options raise issues regarding inter-governmental financial relations which are beyond the scope of this inquiry.

Where the Commission's preferred approach is not practicable, agencies should, as a minimum, adjust the pricing of in-house bids to incorporate all relevant taxes and charges. This is consistent with the approach outlined within the Competition Principles Agreement. As with other costing issues (see section C5.3.4), the financial significance of the exemption will be the key to determining the level of accuracy applied to neutrality provisions. Furthermore, agencies should ensure that any payments or adjustments are based on rigorous, transparent assumptions.

The Commission also notes that competition between not-for-profit organisations and public agencies (and not-for-profits competing against private sector suppliers) has implications for competitive neutrality (see IC 1995d). Where tax-exempt not-for-profit suppliers bid for contracts against similarly tax-exempt in-house suppliers, issues of competitive neutrality may be less pervasive.

However, where tax-exempt not-for-profits compete against tax-liable suppliers, the competitive neutrality issues are similar to those outlined above. One way of resolving these problems would be to exclude not-for-profits from competing with tax-liable suppliers. Another would be to adjust their bids to account for differences in tax liabilities. Both of these options are flawed and present a number of practical problems. Ultimately, problems such as these will be resolved only through broad-ranging tax reform which is outside the scope of this inquiry.

C5.3.4 Costing in-house bids

Competitive neutrality between in-house and external suppliers depends on the accuracy of costing mechanisms employed by in-house teams. It is essential that the costing systems used for in-house bids include all relevant costs. Otherwise, a contract may be awarded on the basis of an inaccurate assessment of the real cost of the in-house bid to the parent agency. A major concern in this regard is the allocation of overheads and other indirect costs attributable to the in-house bid. Participants noted that problems principally arose from the use of inappropriate accounting procedures or costing methodologies.

Accounting systems

The continued use of cash-based accounting in some public sector agencies was identified by a number of participants as a problem, at worst leading to a failure to include the true cost of superannuation and capital equipment in the offer price of the in-house bid.

The adoption of accrual accounting is a means of obtaining better, more reliable, information on which to base resource allocation decisions and assess relative performance. The South Australian Government submitted:

The lack of a consistent accounting framework across government has presented difficulties, particularly due to the differing methods of asset valuation used and the treatment of associated costs. The progressive shift from cash based accounting to accrual accounting will reduce these difficulties ... (Sub. 123, p. 15)

Continuation of current public sector moves towards adopting accrual accounting should reduce the problems associated with cash-based accounting. Most jurisdictions have at least started implementation of accrual accounting. However, it is likely to be some time before these reforms are fully implemented by all Commonwealth, State and Territory Government departments and agencies (see table C5.1).

Table C5.1: Progress towards accrual accounting in Commonwealth and State governments

<i>Jurisdiction</i>	<i>Implementation timetable</i>
Commonwealth	Introduced in some departments in 1993-94, all departments to produce accrual reports for 1994-95 with implementation finalised by 1996-97.
New South Wales	Commenced in budget departments in 1990, by 1993-94 all departments were using accrual accounting.
Victoria	Implemented in many departments by 1994, with implementation scheduled to be completed in 1996-97.
Queensland	Implementation scheduled to finish 1996-97.
South Australia	Implementation scheduled to finish 1996-97.
Western Australia	Prepared supplementary accrual accounts for 1994-95, with accrual recording of transactions expected to commence shortly.
Tasmania	Implementation required to be completed by departments by June 1998. Some commercialised business units and all GBEs already use accrual accounting.
Northern Territory	Some moves towards accrual accounting, though no set timetable for implementation.
Australian Capital Territory	Proposed implementation by 1 July 1996.

Sources: Steering Committee on National Performance Monitoring of Government Trading Enterprises 1995; Tasmanian Government Sub. 288, p. 2; and ACT Government, Sub. 266, p. 13.

For local governments the Commission notes that accounting reforms have been under way for some time, including moves towards adopting accrual accounting. Under accounting standard AAS 27 (operative from July 1993), compliant local governments are required to adopt accrual accounting, recognising all assets and liabilities. Transitional arrangements for infrastructure assets generally provide for a three year phase-in period for these reforms.

One solution to the problem of unfair competition stemming from continued use of cash-based accounting would be to exclude in-house bids for all government departments and agencies until they are operating with complete accrual accounting systems. However, the Commission acknowledges that implementation of full accrual accounting takes time and does not recommend this approach. To do so might unnecessarily prevent efficient in-house suppliers from tendering for service contracts. In addition, it might provide an incentive for not examining the CTC option. Moreover, it is possible for agencies to cost in-house bids applying the same principles that underpin formal accrual accounting.

Recommendation C5.6

Where in-house bids are permitted and accrual accounting is not already in place, contracting agencies should consider accelerating the implementation of accrual accounting.

The Commission notes that the Joint Committee of Public Accounts has released a report dealing with accrual accounting and reporting in the Commonwealth public service (1995b). The report deals with a range of issues, including appropriate transitional arrangements and assistance for agencies moving to implement accrual-based accounting systems.

Allocating costs to in-house bids

The choice of costing methodology is important because an accurate comparison of in-house versus external bids is possible only where the in-house bid includes all relevant direct and indirect costs. For example, the CCF noted:

When an internal tender is submitted, it is only fair that costs associated with payroll, vehicle operation and perhaps even internal rent should be incorporated in the costing structure put forward in the submission. It is possible, from a financial accounting point of view, that an organisation will not ordinarily in fact allocate its overheads, but for the purposes of [competitive tendering] it does need to apply a logically calculated overhead factor with its internal tender submissions. (Sub. 53, p. 54)

This raises the issue of how to deal with such common costs — that is costs spread across more than one output that would still be incurred in total even if only one output were produced. Examples might include the establishment of a payroll system, some of the time of an agency's chief executive officer or commonly used equipment or building space. Such costs are separable to some extent but are generally incurred all together or not at all. For government agencies there are likely to be numerous common costs. Most traditional costing methods are unable to separate all common costs.

To lessen the problem of common costs and determine exactly which costs should be included in in-house bids, two broad approaches may be followed: activity based costing and net avoidable cost.

Activity Based Costing (ABC) aims to improve the way indirect costs (such as payroll services or IT requirements) are apportioned to activities or outputs attributable to the in-house bid. This is done by identifying each organisational support area or indirect cost and allocating these costs proportionately to direct cost activities.

For example, a form of ABC may involve allocating a proportion of all human resource management costs (eg payroll management, administering staff leave entitlements and training requirements) to various work areas based on the numbers of staff employed in each area. Similarly, IT support services may be costed according to the number of computer terminals in each work area, compared with traditional cost allocation systems which might simply apportion all overheads and central services on the basis of the area's proportion of the total agency wages bill. Under ABC, the costs associated with the use of assets would logically be allocated to those parts of the organisation which control their use.

ABC provides agencies with an estimate of the full costs of in-house service provision, allowing for examination of the relative efficiency of in-house providers compared with external suppliers. However, to the extent that a proportion of costs pertaining to an in-house bid will not be prevented if the contract is awarded externally, ABC does not provide the most accurate estimate of likely cost savings from contracting service responsibility. For this purpose, the further use of an Net Avoidable Cost (NAC) methodology is more appropriate.

The NAC approach aims to include all costs which would be avoided by transferring the responsibility for service provision to an external operator (net of any revenue gains). For example, direct costs such as labour and materials, and some indirect costs (such as some personnel functions, payroll administration and other overheads relating to the in-house team) may be avoided should the service contract be awarded externally. As such, these costs should be incorporated into the in-house bid. Other costs, such as some corporate overheads (including generic agency advertising and employing a chief executive officer), may remain fixed regardless of the decision between an internal or external supplier and consequently should not be included in the in-house bid.

To the extent that they would not be incurred if there were no in-house bid, the costs of preparing an in-house bid (including management time devoted towards restructuring the organisation, time and resources spent developing a service supply proposal, and the preparation of a formal tender) would be included in the costs of an in-house bid under the NAC method. Conversely, costs which would be incurred regardless of whether the agency allows an in-house bid (for example, the costs of specifying what type of service is required and drafting the tender documentation) would be excluded under the NAC method.

Importantly, the agency must recognise that a number of costs may be avoided by shifting to an external supplier; yet, realisation of these savings will require

management action. For example, an agency may be able to reduce the office space it occupies by ceasing internal provision of a particular service, but the saving will only be realised if the agency is able to find an alternative tenant (or escapes any leasing commitments) for this floorspace.

The NAC method is recommended in the NSW Premier's Department competitive tendering costing guidelines (NSW Premier's Department 1992) and in the Compulsory Competitive Tendering guidelines for use in Victorian local government.

However, given the added level of examination required under the NAC methodology, this option may be more expensive to implement and operate.

Following the draft report, several participants, for example, the South Australian Government (Sub. 272, p. 7) and the City of Ballarat (Sub. 257, p. 1) acknowledged that they used either the ABC or NAC costing methods or would consider using them, but did not believe that these processes should be mandated. For example, the South Australian Government stated:

We support this methodology and have recommended this basis in our costing guidelines. However, ... in our view, it is unreasonable for the Commission to nominate specific costing methodologies or systems given the significant resource implications associated with implementing these initiatives. (Sub. 272, p. 7)

The Department of Defence argued against the imposition of ABC or NAC for its activities:

Defence does not see this recommendation as appropriate to Commercial Support Program. The current Direct Cost methods ... are considered adequate and appropriate. The Defence Ready Reckoner provides an established and appropriate tool to assist in this process. (Sub. 285, p. 2)

While the Commission agrees that the methods used by the Defence take into account most of the relevant costs and are superior to those used by many other agencies, it notes that not even these methods include all relevant costs (see section B3.2). The use of full NAC methodologies would further improve these methods.

It is not the Commission's intention that any particular costing methodology should be mandated, nor that the resource implications of implementing any systems should be ignored. As the Commission said in the draft report, whatever costing method is employed, agencies should ensure that:

- they avoid overly complex costing systems;
- the issue of materiality is considered — it is not worth going through a costly allocation process for relatively small cost imposts; and

- costing systems are transparent (in terms of underlying assumptions and the calculations themselves), to maintain external confidence in the costing of in-house bids.

Recommendation C5.7

To calculate the relevant costs attributable to an in-house bid (for the purposes of bid preparation), the Net Avoidable Cost method is the preferred method. However, where the Net Avoidable Cost method is too costly to implement, other costing methods such as Activity Based Costing may be more appropriate.

Redundancy costs

Redundancy costs present somewhat of a special case for the costing of in-house bids. For some contracting exercises, the number of redundancies incurred and the associated costs of redundancy payments may be substantial (see chapters C3 and B4). Differences in treatment of redundancy costs are important because, for a given contracting exercise, different approaches may affect the choice of preferred contractor and the contracting outcome.

In practice, these approaches involve:

- treating redundancy costs as ‘sunk’ costs and excluding them from any role in the CTC decision;
- accounting for redundancy costs in the decision to introduce competitive tendering; or
- accounting for redundancy costs when selecting a preferred contractor.

The first approach implies that redundancy costs should be treated as a sunk cost reflecting past management decisions regarding staffing levels. As a sunk cost (that is, an unavoidable liability that, if not realised now, will have to be met sometime in the future, regardless of whether or not CTC is adopted), redundancy costs have no bearing on the relative efficiency of the bids and should not even be considered as a transition cost associated with the move to a CTC framework. Given these assumptions, the agency (or government) should fund the costs of redundancies associated with CTC or other reforms from general revenue.

However, it may be argued that, given an agency’s control over the decision to implement CTC, the associated redundancy costs are not necessarily sunk.

Indeed, a decision to retain internal provision indefinitely may prevent the realisation of (a large proportion of) redundancy costs. Consequently, agencies may consider redundancy costs as a transitional cost associated with the move to CTC, weighing the expected benefits of CTC against the anticipated transitional costs.

Another approach is to incorporate redundancy costs into the contractor selection process, factoring in differences in the numbers of necessary redundancies (and the associated cost differentials) when comparing internal and external bids. In this sense redundancy costs are not treated like other transition costs in that management decisions (to select a specific tender) may be able to change the magnitude of redundancy costs, within a CTC framework. Importantly, because in-house bids are also required to include the redundancy costs associated with their bids, it is the differences in redundancy costs between bids, rather than absolute levels, which are the important parameters.

Governments have followed a variety of approaches to the treatment of redundancy costs in bid evaluation.

For example, the Western Australian Government guidelines (Western Australia Treasury 1994, p. 27) suggest that agencies examine the effects on bidder selection of including transition costs such as redundancy payments. Similarly, the South Australian Government guidelines note that differences in the redundancy or redeployment costs attributable to different bids should be factored into the financial assessment of competing bids and may therefore have some impact on the outcome of the evaluation (South Australian Economic Development Authority 1995).

In Victoria, local government tendering guidelines recommend that redundancy costs which need to be met as a result of CTC be regarded as a capital cost, and be amortised over a period of not less than five years. However, they should be considered only the first time a particular service is subjected to CTC. Redundancy costs should not be considered for shorter term contracts of, say, one year duration (Local Government Industry Working Party 1994, p. 61).

The Commission's report on *Defence Procurement* (IC 1994b) concluded that, as the Department of Defence had to bear any redundancy costs under its Commercial Support Program, it was correct in taking them into account during the tender evaluation process by incorporating differences in redundancy costs between external and internal bidders.

In the context of the current inquiry, the Commission considers that the inclusion of redundancy costs in the evaluation of alternative bids is correct. However, the practical implementation of this approach may be problematic in

some cases, particularly where a negotiated transfer of employees to the contractor is involved (as discussed in chapter C8). There may, for example, be uncertainty over the exact numbers of transfers or redeployments associated with various bids depending upon which bid wins and the number of internal employees who are offered (and accept) positions with the winning bidder. This could affect the decision whether to award the contract to an in-house team or an external contractor.

The Commission also considers that it is appropriate for redundancy costs to be amortised over a suitable period of time, rather than being written off completely at the time of the tender. Even though such costs are only paid by the government once to excess employees, the benefits against which they are compared (that is, the productivity improvements and cost savings from contracting out) often continue throughout the first and subsequent contracts.

In its 1994 report on *Defence Procurement*, the Commission considered it reasonable that Defence amortise the redundancy costs over a ten-year period. It recommended, and the Commonwealth Government agreed, that redundancy (and other transition) costs should be estimated and included in tender documentation. The Commission added that the costs applied must only be the additional costs associated with the transition, and they must not include accrued items such as recreation and long service leave.

As discussed on the last page of appendix E, the choice of an appropriate discount rate will in most cases mean that the period chosen for amortising redundancy costs is likely to range between five and ten years.

Recommendation C5.8

Agencies should estimate redundancy costs, include them in the tender documentation and take them into account in the evaluation of external tenders. Redundancy costs should be amortised over a suitable period, which is likely to be between five and ten years.

The Commission notes that there may be differences between the costs of redundancies as experienced by the agency, and the costs that redundancy imposes on the community more generally. In some instances, the redundancy costs paid by the agency (recognised above as a transition cost) may be offset, to some extent, by a benefit to the community more generally, suggesting that redundancy costs may, in part, be transfers as opposed to transition costs.

This raises similar issues to those discussed in chapter B3, regarding whether cost savings provided by CTC result from productivity improvements or transfers. If redundancy costs reflect transfers as opposed to community-wide costs, they should not be taken into consideration in tender evaluation. However, it is difficult, if not impossible, at present for an agency to determine this 'split' and the approach is not practicable.

Including a rate of return

A number of participants referred to the concept of incorporating a profit component, or rate of return, into in-house bids. It was suggested that the lack of a requirement to earn a commercial rate of return on investments provided an unfair advantage to in-house suppliers (see box C5.2). Other participants argued that this matter should be treated as an inherent advantage of governments, providing benefits to the community generally in terms of cheaper service delivery. For instance, Mudgee Shire Council (NSW) considered:

Council has many advantages that a contractor does not, including no profit margin ... It would seem ... sensible and in the best interests of the community for a tenderer to use any natural advantage in preparing a tender. This should be allowed to apply to Council. (Sub. 164, p. 5)

Similarly, the CCF, NSW branch, submitted that Bega Valley Shire (NSW) deducts profit margins from in-house bids (where they have been included) to compare the 'net cost to council' with external bids (Sub. 125). The CCF argued for the use of the prevailing rate of return in the industry being considered (Sub. 252, p. 7).

The Department of Defence considered that including a rate of return is not appropriate for in-house bids under its Commercial Support Program, on the basis that it is not profit-making in nature (Sub. 285, p. 2).

Several governments support the inclusion of a rate of return when assessing in-house bids. The costing guidelines provided by the Western Australian and South Australian Governments recommend that the opportunity cost of capital be considered when assessing in-house bids (see Western Australia Treasury 1994 and South Australian Department of Treasury and Finance 1995). The ACT Government proposed that all in-house bids take into account the cost of capital (Sub. 266, p. 13). The NSW Premier's Department considered that the cost of capital needs to be given greater emphasis in its guidelines (Sub. 294, p. 6).

The Commission notes that, where a rate of return (or profit) is not adequately incorporated in government investments (including investments in in-house capacity or other capital assets), investment decisions may divert resources away

from those projects offering the best return to the community. In other words, by failing to require that investments seek an appropriate rate of return, the agency is effectively disregarding the opportunity cost of the investment — namely the benefits of alternative investments forgone — and pursuing an investment that may not return the largest net benefit to the community overall. As the Secretary of the New South Wales Treasury has observed:

In the budget sector the only capital cost captured in the budgeting system is maintenance cost, while the accounting system includes maintenance cost and (unfunded) depreciation costs. In neither the accounting nor budgeting systems is there any account taken of the cost of capital, that is, the return that should be achieved in its next best use. This means that there is both an inherent bias to capital intensive processes and in-house provision. In order to achieve competitive neutrality, it is necessary to incorporate in any costing of in-house provision, the opportunity cost of capital. (Lambert 1995, p. 14)

Some participants considered that the cost of capital for government agencies was less than that faced by private sector counterparts, and it was argued that this ‘advantage’ should be factored into the CTC decision. For example, Associate Professor Quiggin argued that the ability of the public sector to spread risk through the tax system has significant advantages over the mechanisms available to the private sector, and:

The superiority of the public sector in handling risk implies that the capital cost of an infrastructure project will, other things equal, be much lower under public ownership than under private ownership. (Sub. 22, p. 6)

However, the Economic Planning and Advisory Commission’s Private Infrastructure Taskforce examined the concept of an ‘equity premium’ (the premium placed on private sector equity compared to the cost of funds to governments, or the real rate of return to government bonds), concluding:

Public infrastructure projects do not necessarily have lower risk adjusted finance cost than private projects. A significant part of the lower public financing costs reflects implicit risks being borne by taxpayers. (1995, p. 74)

The issue of the cost of capital to governments is central to the imputation of a rate of return component for in-house bids. As noted above, much rests on assumptions regarding the capacity of governments, relative to private sector operators, to manage those risks associated with providing various services. These issues are discussed further in Domberger (1995) and Quiggin (1995a, 1995b).

Recommendation C5.9

Agencies should be required to include an appropriate rate of return on capital in costing in-house bids.

Further discussion of these issues, together with the role of sunk costs in determining the appropriate asset base on which to calculate a rate of return, is contained in the report of the Steering Committee on National Performance Monitoring of Government Trading Enterprises (1994), *Guidelines on Accounting Policy for Valuation of Assets of Government Trading Enterprises Using Current Valuation Methods*.

C5.3.5 Improving the competitiveness of in-house bids

Where an agency decides to permit in-house bids, it will have to consider whether to allow some time for in-house teams to 'get up to speed'. This transitional period may reflect the significant cultural change and human resource management issues associated with introducing competitive tendering and in-house bids (see chapter C8). For example, DAS noted:

If an in-house bid is to be allowed, it is reasonable to provide for a period of review and re-adjustment before exposure to the competitive market environment. This includes benchmarking to identify best practice and implementation of necessary improvements. (Sub. 140, p. 63)

Governments have adopted different approaches with respect to transition periods. The City of Melbourne, for example, provided three years for its internal refuse collection workforce to improve to a level where it was able to compete (successfully) with external contractors. But a number of agencies have proceeded with CTC on a tighter timetable.

For example, at the City of Port Phillip (Vic), the in-house teams won the contracts to manage parks and gardens and the library, after being given only a few months to become competitive. Indeed, some local governments in Victoria have found that, once a decision had been made to introduce competitive tendering to a particular activity, the in-house team was keen to shorten the adjustment period and accelerate the reform process.

The Commission considers that there may be good reasons to allow in-house teams a period of time to improve their competitiveness before starting the competitive tendering process. The appropriate period may vary, depending on the reforms required in the agency, but should involve consultation with the employees concerned. Agencies need to recognise, however, that selecting a

long adjustment period will delay the realisation of the benefits of CTC and may threaten the implementation of CTC reforms overall.

In responding to the proposal in the draft report that the transition period be “as short as possible, but no more than two years” (draft recommendation C5.10), the Local Government and Shires Association of NSW said:

A two-year period of competitiveness adjustment is both arbitrary and does not reflect the diversity of councils or communities. A minimal period of four years may even be insufficient for remote small rural councils which will require special consideration. (Sub. 290, p. 15)

The NSW Department of Housing commented that the required timeframe depends on the complexity of the job being contracted (Sub. 256, p. 2).

The NSW Premier’s Department considered that setting a time period for an in-house team to become competitive might “unduly delay needed improvements”, and that the time allowed will vary from case to case (Sub. 294, p. 6).

While recognising that any adjustment period chosen is to some extent arbitrary, the Commission received sufficient indication that internal competitiveness is only realistically addressed when an imminent timetable to face competition is set, to maintain its view that a maximum adjustment period of two years should be sufficient. The period should certainly be as short as possible, so that the community may begin to reap the gains offered by CTC.

Recommendation C5.10

Agencies should specify the period of time that in-house teams are to be given to improve their competitiveness before the competitive tendering process starts. This period should be as short as possible, but no more than two years.

C5.4 Conclusion

The potential benefits and costs of in-house bids, and the appropriate framework under which they should operate, are key considerations in any shift from traditional internal provision to CTC. The decision whether to allow in-house bids should be based on a case-by-case assessment of the relative benefits and costs associated with this option, together with an examination of alternative measures.

Where in-house bids are permitted, this should be premised on agencies providing an appropriate competitive neutrality framework. Particular attention should be given to the organisational structure within which the in-house team operates, including formal separation from service regulation and specification and tender evaluation. Successful in-house teams should also be separated from all aspects of contract management and subject to monitoring and reporting arrangements to ensure that the agreed price and performance standards are achieved.

To achieve competitive neutrality, the Commission prefers corporatisation, although it recognises that commercialisation may be appropriate in some cases. Where governments and/or their agencies choose not to corporatise, they should be required to demonstrate the effectiveness of alternative competitive neutrality measures, particularly in relation to taxation. This requirement is especially important where agencies intend to bid for contracts in non-traditional markets, or engage in loss-leading pricing practices.

C6 THE TENDER PROCESS

C6.1 Introduction

The extent to which contracting of services provides benefits to the client agency, and the community more generally, is dependent on the efficiency and effectiveness of the competitive tendering process. If tendering mechanisms are poorly or inappropriately designed or implemented, the costs imposed upon the client agency and prospective contractors may reduce or overshadow any potential benefits.

A wide range of issues related to competitive tendering processes have been raised by participants — incorporating a range of perspectives. For example, many private and not-for-profit organisations involved in tendering for government contracts drew attention to the direct and indirect costs of participating in tender processes. Likewise, contracting agencies were keen to ensure that their competitive tendering processes operated smoothly and cost-effectively.

This chapter examines the aspects of a successful competitive tendering process, identifying areas where improvements could be made to existing mechanisms. The issues examined include service specification, contract type and incentives, the form of the tender process, mechanisms for evaluating tenders and the facilitation of information dissemination to tender participants.

From this discussion, some ‘best practice’ guidelines for tendering have been developed (see section C6.6 and recommendation C6.1). The Commission has incorporated, where appropriate, the findings of earlier chapters, and built on the discussion of tendering issues from its recent reports into *Defence Procurement*, *Computer Hardware, Software and Related Industries*, and *Charitable Organisations in Australia*.

C6.2 Contract design and service specification

The contract is the formal link between the contractor and the contracting agency. It is the legal structure through which the key elements of the relationship should be made clear (see section B1.3.1).

Contract design involves the identification and documentation of the roles and responsibilities of the various parties involved in the contracting exercise, including:

- the required service and the performance of the contractor;
- how performance will be measured;
- the price and other terms of the supply agreement (including dispute resolution mechanisms and contract termination conditions); and
- how various risks will be allocated between contracting parties.

C6.2.1 Specification of service requirements

In many cases, the specification of an agency's service requirements is relatively straightforward. However, for other services, clear specification of the roles and responsibilities of all parties for all contingencies may be difficult or relatively costly. For instance, it may be relatively simple and inexpensive to design a contract for a supplier to service a council's vehicle fleet at regular intervals. Conversely, a contract outlining the requirements of a counselling service for drug and alcohol dependent clients may be comparatively more difficult (or costly) to specify (see chapter B2).

A number of participants, including the Civil Contractors Federation (Sub. 53) and the Australian Association of Social Workers (Transcript, p. 1666), considered the specification of service requirements crucial to achieving a successful outcome through a competitive tendering and contracting process.

Clear specification of service requirements also assists an organisation to focus on the outcomes or service standards it is trying to achieve. As discussed in chapter C3, the requirement to specify the service to be tendered provides the agency with the opportunity to consider whether the service is being provided at an adequate or appropriate level, whether similar outcomes could be achieved using alternative methods or whether the service is required at all.

Agencies should specify service requirements in clear and accurate terms within an easy-to-follow format.

Performance or design specifications

The specification of service requirements can generally be achieved by documenting either the required process (or design) characteristics of the service or by outlining the required levels of contractor performance. Figure C6.1 illustrates the differences between performance and design specifications.

Figure C6.1: Components of design and performance specifications

Design specifications		Performance specifications	
<i>Inputs</i>	<i>Throughputs</i>	<i>Outputs</i>	<i>Outcomes</i>
<ul style="list-style-type: none"> • staff numbers • facilities • equipment • funding • client numbers • other resources 	<ul style="list-style-type: none"> • processes • tasks • methodologies 	<ul style="list-style-type: none"> • measures of service volume 	<ul style="list-style-type: none"> • measures of client impact

Source: Kettner and Martin 1993

A number of participants argued that specifying service requirements in terms of outcomes or performance could provide contractors with the choice of how to achieve desired outcomes. For example, the Local Government and Shires Associations of NSW considered:

A performance-based brief provides the opportunity for tenders to provide optional solutions to how the brief can be satisfied. However, it is more difficult to manage. (Sub. 54, p. 8)

The benefits of performance specifications may be particularly important where the contracting agency is unaware of the full range of possible ways to achieve the desired end result. For example, the Tasmanian Government referred to a contract where a:

... contractor proposed a change to a road alignment to go through a rock spur so that the rock could be crushed for road pavement. This saved the cost of carting pavement materials a long distance. (Sub. 108, p. 19)

Performance specifications may also shift the technological risk from the client agency to the contractor, that is, to the party potentially most able to manage such risks. In other words, where an agency employs performance specifications, the risk of the supplier investing in technology which may become obsolete is shifted to the contractor. Conversely, the benefits of introducing a new cost-reducing method of service delivery during the term of a fixed price contract would largely accrue to the contractor, through higher retained profits. Nonetheless, contractual conditions could be tailored to ensure that any unforeseen benefits arising from technological advances are shared between the parties. For instance, a cost-plus incentive contract may include provisions for the contracting agency to benefit from a process innovation lowering the contractor's costs of supply (see section C6.2.2).

A number of agencies, at all levels of government, already use performance specifications. For example, in the Department of Defence's Commercial

Support Program (CSP), the Statement of Requirements focuses on outcomes not processes, and must:

- deal with all aspects likely to influence service price;
- prescribe minimum and maximum performance standards;
- outline performance measurement and monitoring mechanisms;
- describe the relevant environment in which the service delivery will proceed; and
- indicate expected volumes of service delivery (Sub. 81).

Similarly, the Victorian Government referred to the use of project briefs for prisons which:

... contain prison management, design and construction specifications based on outcome rather than prescriptive guidelines, and legislative requirements which serve as minimum functional standards to ensure that the Government objectives in relation to enhanced services are met. (Sub. 215, p. 42)

As an alternative to performance specifications, agencies may document service requirements in terms of design characteristics (see figure C6.1). Design specifications offer a higher degree of certainty in terms of tendered solutions and provide a consistent basis for bid evaluation. Further, monitoring contractor performance may be easier under design specifications than with performance specifications. Indeed, the ACTU considered that performance based specifications, including:

Statements of Requirements ... which are written in terms of outcomes (the CSP guidance) are a poor basis for contract management. (Sub. 75, p. 51)

As several participants noted, including the Australian Council of Social Service (Sub. 310, p. 14), for some human or social services it is relatively difficult to measure outcomes. For other types of services, the level of contractor effort (in part reflecting the quality of the service) may not be directly reflected in the outcomes experienced by the clients. However, as noted in figure C6.1, performance specification may focus on a range of outputs (eg the number of counselling hours provided to clients), reducing the emphasis on outcomes which may be affected by a range of factors outside the control of the contractor.

More generally, the Municipal Association of Victoria (MAV 1995a) noted that, for human services:

The nature of the relationship and the 'product' means that service performance criteria and measures are complex, and relatively difficult to quantify and qualify. (p. 9)

In its report on *Defence Procurement* (IC 1994b), the Commission recommended that the Department of Defence use performance specifications wherever possible (with more detailed design specifications used in complex procurements or where specialist components are required). The Commonwealth Government accepted this recommendation. The Commission also noted that greater reliance on Australian and international standards would reduce the need for some technical specifications.

Agencies should adopt performance specifications wherever possible.

Consultation with stakeholders

There are several advantages in consulting broadly with stakeholders on contract specifications.

Obtaining the views of clients or their representatives, as well as existing and alternative service providers, may reduce the potential for incorrect specification of the service as well as lower the risk of discriminatory specification.

A process of consultation may help the agency to specify the service on the basis of what is required at present, not what has been provided in the past.

The Commonwealth Department of Administrative Services (DAS) was among a number of participants to note that significant benefits can be derived from consultation with users and suppliers in the development of specifications (Sub. 140). To facilitate this, DAS sends draft requests for offers for acquisitions of information technology (IT) goods and services to industry for comment.

Similarly, the Department of Veterans' Affairs (Sub. 110) referred to the contracting of health services at Hollywood Hospital (Western Australia). To enable supplier input into the service specification, the Department issued copies of draft tender documentation for comment. It suggested this process helped to ensure all relevant issues were covered, and allowed tenderers to gain a sense of 'ownership' of the project.

The Local Government and Shires Association of NSW (Sub. 290, p. 11) agreed with the need for unbiased consultation with clients. It emphasised the value of specifications being in plain English, and the importance of training people to prepare "across the board" specifications.

The Australian, Liquor Hospitality and Miscellaneous Workers Union (LMWU) (Sub. 245, p. 2) argued that unions which represent those employed in the activity being contracted should also be consulted. The Commission considers

that any consultation with workers on the specification of the service should be handled by incumbent and alternative suppliers.

The NSW Premier's Department considered that consultation with 'industry' would be more realistic and less onerous than a requirement to consult with potential service providers (Sub. 294, p. 6).

The City of Ballarat expressed concern that, if comments are sought on specifications prior to their finalisation, there may be accusations of leaving various interested parties out of the process. It therefore prefers to follow an Expression of Interest approach (Sub. 257, p. 2).

Agencies should ensure that consultation with stakeholders is kept in perspective. As well as the undoubted benefits that consultation provides, it takes time and resources. And considerations such as operational urgency, contract size and security of information should be incorporated into the decision whether to circulate draft tender documentation for comment. There is also a need to ensure that specifications are not unduly influenced by any one stakeholder (eg incumbent suppliers, as discussed in chapter C5).

Community service obligations

Several participants, including the ACT Council of Social Service (Transcript, p. 1207), complained that community service obligations (CSOs) are often not adequately expressed in contracts.

The Commission considers that, where a government agency is delivering a service that includes some CSOs, and wants to continue to have those CSOs provided no matter who delivers the service, it is essential to identify such CSOs clearly when specifying the service and to include a clear statement of the CSOs in the contract.

Improving service specification over time

A number of participants suggested that service specifications in the first contract are rarely perfect. Yet, as the activity is retendered and as the agency gains experience and skills in this area, the likelihood of poor specification diminishes. For example, in reference to the Coastwatch contract, the Australian Customs Service submitted:

A great deal of effort was required to specify ... the outcomes required. ... History indicates that with each successive renewal of the contract we have strengthened our knowledge and understanding of the provision of the service, progressively improving outcomes for the government. (Sub. 187, p. 4)

The Queensland Corrective Services Commission (QCSC) also noted the advances in service specifications that have occurred over successive contracting exercises. For example, the QCSC observed:

... if you go back to the first Borallon contract it was the first one in Australia and, as I said, in the Commonwealth, and we had virtually little or no previous experience that we could borrow from ... what we have had is the benefit of five years' operating experience, seeing other jurisdictions here and overseas embark upon this and look at what they have done, so I guess there were some experiences we learnt from ourselves and what we learnt from looking at other areas. (Transcript, p. 478)

The Commission considers that this 'learning curve' may have important implications for the phased introduction of CTC. Indeed, agencies should take into consideration the likely improvements in service specifications over time when making decisions on putting services to tender. The potential for such improvements also suggests that agencies should introduce service specifications for internal providers in preparation for the possible introduction of competitive tendering.

In addition, agencies can seek to learn from other organisations with greater experience in CTC. Indeed, many organisations already do so when framing service specifications. For example, the Institute of Municipal Management is involved in establishing a facility for local governments to buy and sell service specifications and other tender documentation (Sub. 237, p. 1). Such a facility would reduce unnecessary duplication in service specification and contract development, and would encourage local governments to learn from the experiences of others. It is intended that this facility be offered to local governments through a nationally accessible database, possibly incorporating a tender directory for prospective contractors.

C6.2.2 Types of contract

There are a range of possible contract types which may be used for service contracting. These include fixed price contracts, incentive contracts, variants of cost-plus contracts, management fee contracts and period contracts. The choice between these contract types will depend on the nature of the service and the appropriate contractual incentives and penalties required.

In a *fixed price contract*, the government and the contractor determine a mutually agreeable price for a given quantity and quality of the service to be provided. This form of contract is most suitable where there is a good understanding of the likely cost of the service, where the level of demand is predictable and where the activity can be clearly defined. Pacific Waste

Management considered that there is considerable benefit in this form of contract:

In waste management, contracting out offers the benefit of having a fixed cost under the terms of the contract. It eliminates the need for costly maintenance facilities and staff, and the risk of unscheduled and inappropriate cost fluctuations. Standard/fixed cost operating makes the budgeting process more meaningful and accurate. (Sub. 52, p. 5)

By reducing the uncertainty associated with cost fluctuations, the likelihood of costly contract variations also is reduced. As the National Archives pointed out:

The Archives' own experience of contracting out indicates that a fixed price contract is preferable, if practicable, to protect the Commonwealth's interests from possible claims over and above the contract price. (Sub. 97, p. 4)

However, it can be argued that such contracts offer little incentive for contractors to increase the level of output or service quality. Where income is assured, profit margins may be widened by lowering quality and therefore cost. This may be of particular concern for services where quality is harder to define and monitor. The Australian Medical Association observed:

A fixed price contract may provide undesirable incentives to ration care. There would be incentives to maintain or reduce the mix of cases dealt with under a contract to control costs. This has been the experience in USA. (Sub. 63, p. 3)

Nevertheless, an agency may provide an incentive for tenderers to offer a higher quality service within the framework of a fixed price contract by setting the price and selecting a preferred contractor on the basis of quality characteristics (see box C6.1).

Where quality outcomes are particularly important, a contract may encourage improved quality through the incorporation of quality assurance prerequisites (see chapter C7) or incentive payments linked to the achievement and maintenance of specified standards. *Incentive contracts* may include provisional payments linked to a range of performance criteria, including timeliness of delivery, achievement of agreed quality standards or client satisfaction as determined by client surveys. Generally, a minimum standard is set and incentive payments are payable if higher standards are met and sustained over given periods.

Fixed price contracts give contractors an incentive to minimise cost, yet the agency does not share in any of the realised savings. As an alternative, a *cost-plus incentive contract* provides for contractors to receive a fixed fee, plus a set proportion of the amount by which the contractor's actual costs are below a pre-specified cost level (say, the previous cost of internal provision). With this contract, an agency may be able to access a proportion of the benefits from an unanticipated cost reduction (eg due to the introduction of a new supply

technology or process). The Australian Information Industry Association noted the contract between Challenge Bank and Ferntree Computer Corporation reflects some of the characteristics of a cost-plus incentive contract:

The contract enables Challenge and Ferntree to work together to share risk and reward. It includes an incentive scheme under which Ferntree is paid a bonus for reducing Challenge's costs further than those agreed upon in the contract. (Sub. 98, p. 17)

Box C6.1: Evaluating quality using a set price

The Employment Services Regulatory Authority (ESRA) was established in 1994 to regulate, accredit and administer contracts with private and community case managers. These Contract Case Managers (CCMs) provide case management services to unemployed clients on referral from the Commonwealth Employment Service.

The tender model currently used by ESRA involves a fixed price tender where CCMs compete for job seekers on the basis of quality. Payment is determined by the placement outcomes experienced by each client, with each CCM offered the same schedule of rates versus placement outcomes. ESRA evaluates the quality of competing CCMs on the grounds of expertise, experience, demonstrated success in similar ventures, financial viability, organisational stability and proposed case management regime.

ESRA chose a tender model based on quality evaluation because of the lack of experience in the private and community case management market, together with its lack of experience in managing such contracts. However, ESRA noted that, when a clearer understanding of 'high quality' case management is available, price may enter the evaluation decision more directly.

ESRA added that, although it evaluates tenders on the basis of quality rather than price, as case managers are remunerated to some extent in line with their performance, in practice the contract is not really a fixed price contract. ESRA considers its approach to be a mix of tendering on the basis of quality and rewarding on performance.

Source: ESRA, Subs. 139 and 278

The cost-plus incentive contract builds on the basic *cost-plus contract* (payments are set at actual costs plus a profit margin) which provides no incentive for the contractor to contain costs. Cost-plus incentive contracts are most appropriate where agencies are reasonably sure of the costs of service provision, but wish to ensure that they share in the gains from any unexpected cost reductions.

Where project costs cannot be estimated with any precision, a form of *management fee contract* may be appropriate. The price paid to contractors may be determined by reference to either the costs of inputs or the achievement of specified outputs, depending on the nature of the project. Skilled Engineering

supported the use of management fee contracts, particularly when ‘partnering’ between the agency and the contractor is important:

... experience has shown that a partnering arrangement linked to a Management Fee type contract can deliver real business benefits to clients. Management Fee contracts inevitably encourage transparent co-operation between the partners through structure procedures, constant performance measurement and frequent joint reviews of performance. (Sub. 69, attachment, p. 4)

Period contracts are used when a contractor is engaged to provide services or expertise in a specified discipline on an ‘as required’ basis at a pre-negotiated fee. Such contracts are considered useful because they enable the contracting agency to engage contractors when required without having to repeat the selection process and fee negotiations on each occasion. For example, the Australian Agency for International Development employs consultants on period contracts, enabling the agency to select consultants for short-term projects without the costs of overly frequent tenders (Sub. 47). However, agencies need to guard against reductions in service quality by ensuring that the contract is contested at regular intervals.

The Commission notes that a range of contract types may be used by contracting agencies. Agencies should select an appropriate contract type based on the characteristics of the service and the nature of the appropriate contractual incentives and penalties required to achieve the desired outcome.

C6.2.3 Incentives and penalties in contracts

The form of contract chosen, and the range of incentives and penalties able to be incorporated in various contract types, can have a significant effect on the outcome. For instance, incorrect or inadequate contract specification may lead to unforeseen reductions in service quality. If the contract is not appropriately designed, contractor behaviour may not live up to expectations.

One way to avoid these problems is to ensure that the contract includes appropriate incentives to improve performance during its life. Incentives and penalties can be introduced into all types of contracts to secure a range of project objectives, including expediency and innovation. For example, the Association of Consulting Engineers Australia noted:

In the private sector, if the client wishes to achieve some particular goal in a project, early completion for example, then financial incentives are arranged with the consultant. There are a whole raft of terms of engagement which can be used to provide consultants with performance incentives which can be used with probity. (Sub. 38, p. 13)

Similarly, ISSC Australia suggested “incentives for producing higher quality solutions are an important step in requiring a longer-term approach to contracts and assessment” (Sub. 88, p. 5).

Drawing the link between incentives and encouraging innovation, DAS observed “innovation can also be fostered through the provision of incentives in contracts which reward suppliers for introducing improvements” (Sub. 140, p. 50).

However, the Department of Defence expressed some reservations on incentive contracts:

Whether or not to use incentives in contracts for services is linked to the overall setting of performance standards. ... Incentive contracts should only be considered where a benefit to Defence will arise from the higher standard being obtained. If there is no benefit to Defence there is no justification for the greater payment. The best example of a benefit warranting an incentive structure is where there is an efficiency gain to be made of a greater value than the incentive payment to be made. (Sub. 81, p. 37)

Concern was expressed that, while some contract managers have demonstrated a willingness to use penalty clauses in contracts there is a reluctance to incorporate incentives or bonuses. Boral Asphalt commented “Penalties are often used to elicit performance. The use of incentives is very rare and this should be encouraged” (Sub. 120, p. 16).

Domberger and Hensher found:

Relying on positive incentives and negotiation rather than financial penalties also appears to be an effective way of raising contractual performance. (1993, p. 452)

Penalties alone do not provide encouragement to perform above the minimum necessary. Instead there needs to be a balance of incentives and penalties. This point was recognised by the President of the Australian Law Reform Commission:

A well-judged mix of incentives and penalties rather than penalties alone are, in my experience, the appropriate mechanisms to encourage effective performance. But again they must be tailored to the particular situation and not applied as a matter of course from standard forms. (Sub. 64, p. 5)

Performance bonds are a contingent ‘penalty’ used to shift a proportion of the risk of contractor failure from the client agency to the contractor. A number of participants referred to them as a way to encourage improved contractor performance and to protect the agency from the costs of failure. For example, Pacific Waste Management noted:

The assurance of quality through the contracting out process could be greatly assisted by the introduction of performance bonds. This is based on the assumption that measurable criteria for performance can be established. (Sub. 52, p. 4)

However, other participants considered that the extent to which performance bonds contributed to acceptable contract outcomes was debatable. For example, the Tasmanian Government submitted:

Currently there is no documented evidence that penalty, incentive clauses or performance bonds elicit performance. (Sub. 108, p. 31)

It seems to the Commission that performance bonds may act as a disincentive to contractor participation where they are set with little regard to the optimal distribution of risk. But there may be occasions when agencies find them appropriate. In the end, it is the blend of contractual incentives and penalties which holds the key to encouraging good performance.

A mix of incentives and penalties should be considered for any contract.

C6.2.4 Dispute resolution

Given the complexity of many services, the inexperience of some contracting agencies and contractors and the levels of uncertainty in some markets, disputes may arise over the role and responsibilities of respective parties. Such disputes need to be resolved in a quick, cost-effective manner to ensure that the associated costs do not undermine the benefits of CTC.

Dispute resolution clauses may be included in contracts to provide direction to parties in the event of a contractual dispute. The rationale underlying the wide range of dispute resolution provisions available is the desire to resolve problems, where possible, without the use of costly, time-consuming court conflicts and other formal legal processes. The Australian Commercial Disputes Centre (ACDC) argued that non-court dispute resolution is able to provide solutions 90 per cent cheaper and 95 per cent quicker than through available court mechanisms (Sub. 9, p. 4).

These provisions typically set out timetables for negotiations between the parties, conditions for use of external mediation, expert appraisal or perhaps even binding arbitration as a means of solving cases of contract failure. However, for those cases where agreed dispute resolution procedures are unable to produce an outcome acceptable to both parties, the option of last-resort court action may still be employed.

In each of the eastern States and the Australian Capital Territory, Community Mediation Centres have been established to assist in the resolution of various types of disputes. These Centres are run or supported by their respective state or territory governments, and provide services free of charge (The Resolution Centre, Sub. 242).

Some participants suggested that it should be compulsory for some form of non-court dispute resolution to be included in all government service contracts. For instance, ACDC submitted that:

Matters relating to the resolution of disputes should be included in all contracts. Simple dispute resolution clauses usually provide that if the parties to the contract and dispute do not resolve the dispute within seven days, then the dispute is to be referred to ACDC for a specified dispute resolution process. Public agencies may specify a combination of methods which would provide parties to contracts with a great amount of flexibility when it comes to the resolution of disputes. For example, a mediation may be followed by an expert determination or an arbitration. (Sub. 9, pp. 7-8)

The Commission recognises the benefits that appropriately applied dispute resolution procedures may provide, and suggests that agencies should consider including non-court dispute resolution processes in service contracts. Individual agencies should be free to determine the type of non-court dispute resolution procedures to be used.

C6.2.5 Allocation of risk

The sources of risk in contracting include operational risks, regulatory risks and technological risks.

Operational risks refer to the likelihood that the contractor will be unable to fulfil service delivery according to agreed timetables, quality requirements or cost constraints. For example, the risk that a contractor will be unable to provide the service at the agreed contract price (without making a loss) due to an unforeseen increase in the cost of inputs is a type of operational risk.

Regulatory risks refer to those risks pertaining to the regulatory environment within which the contractor operates. For example, regulatory risk includes the chance that mandatory employment conditions covering superannuation or occupational health and safety may vary unexpectedly during the life of the contract.

Technological risks are those risks surrounding changes to the technology incorporated in the supply process. For example, a particular supply process may become obsolete or the need for a particular service may be reduced given technological developments and innovation.

The Commission was informed that public sector agencies engaging in contracting have often attempted to transfer as much of the risk to the private sector as possible. The President of the Australian Law Reform Commission observed:

Having been in a superior position in all major contracting out situations, the departments I have worked in have driven (in hindsight it seems to me) too hard a bargain putting all major risk on the contractor, in one situation resulting in multi-million dollar losses to the contractor and extended litigation. (Sub. 64, p. 4)

Where agencies attempt to transfer all risks (and the associated costs) to the contractor, it is likely that this will be reflected in higher costs to the agency in terms of inflated tender prices or increased risk of contractual failure. However, where the risks are borne by that party best able to manage them, costs are minimised. For example, the number of meals required by a hospital may depend on the hospital admissions policy (eg a shift towards day-surgery rather than overnight stays), suggesting that the risk of fluctuations in meal demand should be borne (in part) by the hospital administration. Yet, the risks of changes in food preparation technology would appear most appropriately carried by the contractor. As the NSW Premier's Department observed more generally:

The fundamental principle of efficient risk allocation is that the party most able to influence and control specific risks should be assigned the responsibility for that risk. This may mean a sharing of the risks between the private and public sector or a full assignment of risk to the private sector. (Sub. 199, p. 6)

Building on this general principle of risk allocation, Associate Professor Quiggin suggested:

... governments should bear risk related to changes in regulatory policy and risk related to capital intensive project[s], while risk specific to the operation of particular activities should be contracted out as far as possible (Sub. 22, p. 26)

Indeed, one benefit associated with service contracting is that it provides an opportunity to spread those financial or market risks which may be better carried by the private sector than by government. For example, by specifying outputs rather than inputs, governments are able to shift some risks of changes in input costs or supply technologies to the private sector. This option may be particularly appropriate for services where there is a high rate of technological renewal or heavy reliance on technology and where a specialist contractor is best able to handle these risks.

Regardless of how risk is distributed through the contract, there is a danger in focussing too narrowly on the contract itself as a risk management device. It is necessary also to focus on management techniques to effectively reduce the risk of contract failure (see chapter C7). The extent of incentives for public sector managers to accept risks (see chapters C1 and C2) is also important. Indeed, addressing risk allocation problems first requires addressing these fundamental incentives.

To minimise the total cost of the provision of a service, agencies should identify the risks involved in each case and allocate the risks to the party best able to manage them.

The Commission notes that the Commonwealth Management Advisory Board (MAB–MIAC 1995) has produced a draft report dealing with risk management in the Australian Public Service. The draft provides guidelines for public service staff, stresses the importance of risk management and outlines processes for the identification, analysis and treatment of risks.

C6.2.6 A role for standardisation

Good contract design is not costless. For many contracting exercises, particularly those involving large, complex or unfamiliar activities, the costs of identifying and specifying service requirements are substantial, particularly in terms of management and staff time. Similarly, the process of drafting contracts may be costly, with time and effort directed at identifying and documenting the role and responsibilities of various parties.

Standardisation may also lower the costs of submitting tenders for those who bid for more than one government contract, since they avoid the training and administrative costs required to deal with a variety of contract formats.

Standard contracts provide a base contract, flexible enough to facilitate the incorporation of service or organisation-specific requirements, while reducing the need for individual agencies to reinvent the wheel. Where services or products are contracted frequently, or where similar client-contractor relationships exist in other cases of service/product provision, a number of participants suggested a role for standard contracts. For instance, the Local Government Association Mutual Liability Scheme:

... identified the need for a system to be developed which would ensure a more effective means whereby councils could better manage their many and varied contracts. This led to the development of a number of standard contract documents to assist councils with the preparation of their own public works and consultancy contracts. The development of standard contract documents within local government as an industry was seen to produce benefits for both local government and the community at large. (Sub. 192, p. 1)

For local governments in particular, standardised contracts offer scope to reduce costs, as they frequently contract similar services. Indeed, Hobart City Council pointed to the lack of standard specifications for local governments as a particular problem:

The development of specifications is made all the more difficult because of the absence of standard form contracts, capable of being adapted for local usage. Most councils moving towards contracting out are 'reinventing the wheel' ... (Sub. 153, p. 20)

The Local Government and Shires Associations of NSW supported:

... the development of standard documentation to assist councils draft adequate specifications and facilitate contract management. (Sub. 54, p. 10)

However, agencies need to ensure that standard contracts are flexible enough to accommodate differences in conditions between contracting exercises. For example, the Australian Customs Service was critical of the treatment of risk under the standard contract for Commonwealth IT purchases:

The Commonwealth generally [is] considered to be 'risk-averse' and standard contract[s] aim to reduce the Commonwealth's exposure to risk. This is suitable for 'purchase' style contracts, but is more difficult in instances where any degree of partnership is involved, as in the case of various 'services' that agencies may contract out. ... agencies need to be prepared to enter contracts that involve some risk sharing. (Sub. 187, p. 7)

The Local Government and Shires Association of NSW noted that Standards Australia is developing general contract conditions for a number of service areas (Sub. 54, p. 10). Indeed, Boral Asphalt (Sub. 120) considered that the general conditions of contract provided by Standards Australia (AS 2124 and AS 3556) were a useful basis from which to build individual contracts. Standard contract specifications/documentation have also been produced by a range of Commonwealth and state departments (including the Department of Defence), as well as through industry organisations such as the Construction Industry Development Agency.

The Commission notes also the proposed establishment by the Institute of Municipal Management (Victorian Division) of a facility for local governments to buy and sell service specifications and other tender documentation (Sub. 237, p. 1). Such a facility may help to provide greater standardisation of contracts over time.

Standard contracts may also assist in the development of a standard range of performance monitoring criteria, reducing the potential for wasteful duplication in standard setting between jurisdictions.

Standard contracts and other standardised documentation have the scope to reduce tendering costs, while retaining necessary differences in service characteristics and contractual relationships between services, agencies and locations.

Agencies should use standard contracts and other standard documentation wherever possible.

C6.3 The form of tender process

Once service requirements have been identified, the agency must decide on the appropriate form of the tender process. At a broad level, this choice involves selecting between single or multi-stage tendering.

C6.3.1 Single stage tenders

Under a single stage process, or open tender, tendering is open to all. Offers are expected to address the full range of criteria and conditions specified in the tender documentation. This generally means tenderers need to provide a large amount of information, including on design or performance characteristics, and on their financial and organisational capacity to satisfy contract requirements.

While open tenders may maximise the number of potential contractors, they may impose significant cost burdens on tenderers and contracting agencies. Serco Australia stated that its average cost to prepare a tender for significant projects was approximately \$60 000 (Sub. 144). The Electrical Contractors' Association of Queensland estimated the costs of preparing a conforming tender to be:

... around 5 per cent of the contract value or more for services where Bill of Quantities [a list of the inputs required] are not normally provided. (Sub. 182, p. 3)

For large and complex contracts in particular, the cost burdens imposed, combined with the risk of not actually winning the tender, may contribute to a reduction in the number of potential competitors. In any case, the risk-weighted cost of participating in an open tender would generally be added to the overall bid price submitted, adding to the costs incurred by the contracting agency. Skilled Engineering submitted:

... the cost of submitting a tender is directly proportional to the details sought in the tender documentation and the scope and technical complexity of the work involved. Large technically complex tenders worth millions of dollars clearly warrant considerable contractor input and such bids are costly to prepare and present. ... Smaller and less complex tenders are less costly to present. Contractors only become concerned when voluminous tender documents are used for simple low cost proposals. (Sub. 69, p. 16)

This concern is recognised in the literature on competitive tendering. Indeed, Hibbert and Hanly (1995) noted:

... highly contested open tenders ... are often wasteful of the scarce resources of tenderers and clients alike. (p. 8)

For the contracting agency, the costs of evaluating a large number of tenders may be substantial. For example, the Commonwealth Department of Human Services and Health commented:

More open processes have not, in the past, always proved successful. In many instances large numbers of non-competitive expressions of interest have been received from organisations with little or no experience in the field which, nonetheless, require examination with consequent administrative costs to the program. (Sub. 226, p. 18)

C6.3.2 Multi-stage tenders

An alternative to the use of open tendering is the multi-stage tender process. It has the advantage of reducing the field of potential competitors in the initial stages of the process, leaving the agency with a manageable number of tenders to evaluate. Similarly, those with little chance of winning a contract are spared the costly and time consuming process of preparing a full tender, while those contractors successfully satisfying initial tender stages are able to more accurately assess the risks of winning the contract and factor this into their bid accordingly.

Multi-stage tendering may be useful where complex service requirements mean the costs of preparing a response to a Request for Tender (RFT) are substantial. However, tendering costs may remain unnecessarily high where agencies request more information than is required at each tender stage.

A multi-stage tender process enables the shortlisting of tenderers through an initial invitation to register interest or expression of interest (ITR/EOI), or a request for proposal (RFP). This allows the contracting agency to evaluate the respective general approaches at a preliminary stage before requesting a limited number of interested bidders to undertake the more costly preparation of a full tender. This is particularly useful where the agency is unsure of the range of potential solutions which may provide acceptable outcomes.

Short-listing may also be achieved through the adoption of a 'prequalification' stage. This stage involves issuing invitations to participate in further stages of the tender process (eg RFPs or RFTs) on the basis of specific criteria. For example, contractors may be prequalified on the basis of some or all of the following factors: a demonstrated capacity to satisfy service requirements, quality assurance criteria, technical resources or expertise, financial history or perhaps performance with regard to occupational health and safety issues. Alternatively, the existence of sensitive information in tender documentation (eg information relating to national security issues within Defence projects) may justify shortlisting contractors to those with demonstrated experience in handling such information.

Prequalification or similar short-listing stages must allow for the possibility of short-listed contractors withdrawing from the process. The Department of Veterans' Affairs (Sub. 110) noted that, for the Hollywood Hospital tender

process, a shortlist of three companies was barely adequate. One late withdrawal left the Department with two competitors and a reasonable degree of competition; however, further problems with either of the remaining tenderers could have raised complications.

It is likely the optimum number of short-listed tenderers will vary between agencies and activities. For example, the Commission noted in its *Defence Procurement* (IC 1994b) report that, particularly for major capital acquisitions or where the costs of tendering are substantial, requesting tenders from two or three contractors should be adequate. In the context of this inquiry, some activities may justify a greater number of short-listed tenderers. For example, where greater levels of uncertainty exist as to potential solutions or where the costs of preparing a tender are not excessive, agencies could consider sending RFTs to a larger number of contractors.

The Commission considers that, where practicable, multi-stage tendering provides significant scope for reductions in tendering costs. Indeed, the Commission's report on *Defence Procurement* (IC 1994b) recommended that the Department of Defence "proceed with multi-stage tendering involving more rapid shortlisting and less documentation than at present" (p. 113). The Commonwealth Government accepted this recommendation, noting that "Defence is using appropriate tendering stages and has a policy of using shortlisting wherever it is clear tenders are no longer competitive" (Ray 1995). In its submission to this inquiry, the Department of Defence commented:

The nature of the activity is the prime determinant as to whether and how multi-stage tendering should be used. (Sub. 81, p. 29)

The Commission considers the use of multi-stage tendering should generally be adopted, particularly where:

- **service requirements are unclear or several solutions potentially exist;**
- **the service requirement is relatively complex (and requests for tenders costly); or**
- **security or quality considerations suggest that reductions in the number of tender respondents to 'known quantities' is advisable.**

Further, agencies should seek no more than the information that is required at each stage of tendering.

C6.3.3 Tender timetables

The timing of tender stages, and the timing of tender processes more generally, can have a significant effect on the ability of potential bidders to submit the

necessary information. Indeed, a number of submissions raised concerns with excessively tight tender timeframes or delays between tender stages.

At one extreme, box C6.2 outlines the experience of Pacific Waste Management (PWM), primarily focussing on the short timeframes allowed between tender stages. Likewise, the Civil Contractors Federation, Victorian branch (Sub. 109), noted a case where the RFT gave some prospective bidders, allowing for posting, less than two working days to prepare and submit a tender.

However, the other extreme of unnecessary delays between tender stages also imposes costs, both for potential contractors and the client agency. For tenderers, costs are incurred in the form of the opportunity cost of maintaining a bid team, while contracting agencies must continue to devote staff and other resources to an on-going tender process, potentially at the expense of other worthwhile activities.

Differences in service characteristics will influence the amount of information contracting agencies require from tenderers. Consequently, the appropriate time between tender stages will vary between agencies and services.

Problems may also arise where agencies notify tenderers of proposed tender timetables, yet fail to adhere to them. This makes advance planning particularly difficult and is likely to impose additional costs on tenderers, ultimately increasing service costs. These concerns were raised in the Commission's inquiry into *Defence Procurement* (IC 1994b).

To address these concerns, the Commission considers that contracting agencies should notify participants of tender timetables as early as possible and adhere to them.

Box C6.2: Tender timeframes — the PWM experience

Pacific Waste Management (PWM) is the local subsidiary of a large multinational corporation headquartered in London. The core business of PWM, and that of its ultimate parent company, is the reduction, collection, recycling and treatment of waste materials from residential and industrial sources.

Contracts won through a tender process are a significant proportion of the company's revenue base — at times contributing to as much as 30 per cent of the operating revenues of some divisions and branches. These tenders range from large projects — including a contract with the Brisbane City Council for the transport and disposal of waste — to smaller contracts with rural local governments.

One particular problem encountered by PWM in its dealings with local government tender processes, has been the inappropriate lead times provided, in some cases effectively preventing contractors from preparing adequate tender applications. As an illustration, PWM submitted that the Shire of Bacchus Marsh (Vic) had advertised a tender on 9 November 1994, with tender applications closing a week later on 16 November. PWM noted similar concerns for several other tenders administered by the City of Brighton (Vic) and Moreland City Council (Vic).

From its experience, PWM considers that a lead time of at least 30 days is required to allow bidders to adequately prepare and collate the information required by the client agency. In the opinion of PWM, without adequate allowances for necessary tender preparation, potential contractors may be discouraged from bidding, with associated reductions in competition.

Source: Pacific Waste Management, Sub. 52

C6.4 Tender evaluation

In some cases, the evaluation of competing offers is relatively straightforward, particularly where the bid price is the only, or most important, evaluation criterion. However, where 'value-for-money' (see box C6.3) is the key criterion, tender evaluation may become a complex and difficult procedure. For example, chapter C5 discusses the evaluation of in-house bids competing with external tenders, focussing on the potential problems in calculating an appropriate basis on which cost comparisons can be made. This section examines evaluation mechanisms, with particular emphasis on the assessment of non-price (or quality) considerations.

Box C6.3: Evaluating value for money

The objective of value for money is a central component of successful CTC models. Aiming for value for money means that agencies should look not only to price considerations, but also to considerations such as quality, suitability for purpose (or effectiveness), whole-of-life costs, post-delivery service, and the supplier's flexibility. For example, DAS submitted:

The value for money objective requires that procurement decisions must not be based on price alone but must take into account all relevant considerations including, for example, fair price, quality, delivery arrangements, inventory and warehousing, contractor capabilities and whole-of-life costs where appropriate. (Sub. 140, p. 10)

Likewise, the South Australian Government noted:

Competitive tendering and contracting is applied to achieve best value for money. In making the assessment there is a trade-off between risk and net benefits, with price being only one factor for consideration. For example, some of the price and non-price factors to be considered include, but are not limited to, competency and experience of contractors, fitness for purpose, costs over the contract period, likely state of the market at the end of contract period, financial stability, quality of service and public access to services at affordable prices. (Sub. 123, appendix A, p. 2)

C6.4.1 Evaluating price and quality characteristics

Some participants expressed concern that the nature of competitive tendering leads to a focus on cost issues, with evaluation decisions based almost solely on price. For example, the ACTU suggested:

Competitive tendering is essentially a cost cutting measure which compels agencies and employees to lower costs through bidding on a lowest cost basis.

... it is clearly against the interest of contractors to include in the contract service quality issues which may raise their costs. (Sub. 75, pp. 7 & 23)

However, the price variable is only one criterion that may be considered in the evaluation. For example, a tender for the supply of a relatively standard service (eg trimming footpath edges) may be awarded primarily on the basis of price, with service quality monitored and acted on where appropriate. Conversely, a contract for the maintenance of a city's bus fleet would most likely incorporate consideration of non-price attributes such as proposed service schedules, the quality of service mechanics and perhaps the past performance of the contractor.

The Commission received a large number of submissions detailing the various types of evaluation criteria employed by contracting agencies, including a range of non-price characteristics. For example, Launceston City Council (Sub. 29) noted that the contractor's overall experience in similar projects, key personnel, concurrent commitments likely to affect its capacity to satisfy the terms of the contract and various qualifications included with the tender were all taken into

account during the evaluation process. Other participants listed similar evaluation criteria. The common link between these evaluation processes was the intention to produce an outcome reflecting 'value for money', not simply the lowest cost option (see box C6.3).

Ranking and weighting evaluation criteria

Many agencies employ a system of ranking or weighting evaluation criteria, assessing each tender's compliance with a variety of criteria to help determine the preferred tenderer.

In some cases agencies apply weightings rigorously, calculating quantitative values to represent qualitative factors and applying weightings to obtain a 'bottom line' figure from which the preferred bidder can be selected.

Other agencies use broader rankings to simply classify characteristics as more or less important, evaluating alternative offers with these qualifications in mind. For instance, the Australian Agency for International Development submitted that its evaluation practices placed a 70 per cent weighting on technical merit, with the remaining 30 per cent allotted to the tender price (Sub. 47).

A number of participants suggested that a list of evaluation criteria should be included in tender documentation, together with the weighting for each criterion. This approach is said to assist contractors to prepare a tender suited to the agency's requirements, while eliminating situations where resources are devoted to developing costly proposals aimed at low priority service objectives. For example, the Australian Information Industry Association suggested:

There should be clear weighted selection criteria to enable IT&T companies to determine whether and how to bid. (Sub. 98, pp. 10-11)

Including evaluation criteria, and rankings or weightings, in the tender documentation may assist the agency to enhance the objectivity of the evaluation process. The scope for favouritism or corruption is lessened where the evaluation team has less scope to employ subjective evaluation mechanisms.

Other inquiry participants were less concerned with this issue. Skilled Engineering noted:

It is up to the tenderer to determine whether or not they wish to publicise the criteria and weighting or to keep this information confidential. Either approach is acceptable ... Impartiality and appropriate division of responsibilities within the tender process are the real keys to effective probity in bid assessment work. (Sub. 69, p. 16)

At present, the approach towards publication of evaluation criteria and weightings varies between agencies. At the Commonwealth level, the Department of Social Security (Sub. 138) submitted that its tender

documentation generally includes evaluation criteria and weightings, while the Department of Defence (Sub. 81) stated that its RFT documents indicate which criteria are more or less important. Other agencies, including the City of Melbourne (Sub. 89), submitted that evaluation criteria and weightings are determined in advance, though not made public.

In part, such actions may be premised on concerns that publicising evaluation criteria and weightings may inhibit the agency's ability to exercise qualitative judgment as the tender evaluation process proceeds. For instance, the Commission's *Defence Procurement* report noted:

The inclusion of specific weightings in RFTs might increase industry's confidence in the transparency of the selection process. But it would limit Defence's flexibility to adapt its requirements in the knowledge of what is offered by the various tenderers, thereby putting in jeopardy achievement of the value-for-money objective. (IC 1994b, p. 112)

In its report on *Charitable Organisations in Australia* (IC 1995d), the Commission suggested that the selection criteria used to evaluate alternative service providers should be explicitly identified and prioritised in tender documents. The Commission's *Defence Procurement* (IC 1994b) report recommended that selection criteria, together with relevant rankings, be included in RFT documentation.

Agencies should specify and rank relevant evaluation criteria in tender documentation. However, agencies should be free to determine whether tenderers will be informed of any precise weightings to be applied to these criteria.

Qualification based selection

Some participants suggested that, even where ranked or weighted evaluation criteria were employed, agencies retained a bias towards lower prices at the expense of quality outcomes. For example, the Association of Consulting Engineers Australia remarked:

It is clear that all too often, disproportionate weight is given [to] the low price bidder at the expense of quality when the two factors are considered together at the selection stage. (Sub. 38, enclosure 2, p. 3)

To overcome this problem, some participants suggested the adoption of a selection process known as Qualification Based Selection (QBS). QBS operates in a fashion similar to the prequalification process detailed earlier. A basic form of QBS involves the agency issuing a Request for Qualifications to a range of potential contractors, including broad details of the client agency's service requirements. From the respondents, the agency selects three preferred bidders

(on the basis of qualifications, demonstrated competence and capabilities), and commences negotiations with the most highly qualified to finalise detailed service specifications, contractual terms and the contract price.

The Association of Aerial Surveyors considered QBS to be suitable for the procurement of surveying, mapping and photogrammetric services, due to the difficulty of defining adequately the quantity and quality of services to be provided in advance of negotiations (Sub. 101, p. 3).

Discipline over the price variable is said to be maintained through the option to negotiate with either of the two remaining bidders where an adequate outcome cannot be realised with the first choice contractor. The Association of Consulting Engineers Australia (ACEA) submitted:

QBS focuses on helping clients find the best qualified people for their project, and then helps negotiate a fair price for the appropriate level of service. (Sub. 38, p. 7)

Successful negotiation of the contract under the QBS approach requires that the contracting agency have a good idea of the market price for a particular type of service.

QBS may be useful for complex projects where quality and client satisfaction are paramount outcomes. QBS may be particularly relevant where it is difficult or costly to monitor accurately the performance of the contractor in achieving these objectives. In this sense, the qualifications of the contractor act as a proxy for service quality, allowing the agency to by-pass more costly methods of quality measurement or performance monitoring.

However, it is important that the use of QBS selection processes does not become a de facto mechanism to restrict competition by reducing the field of potential competitors and, by implication, the number of price/quality service bundles offered to the contracting agency. Where these concerns exist, agencies should consider other tender models which provide the benefits of QBS (in terms of better value for money) without restricting competition.

Where QBS is used, many of the service specifications will often not be determined until a preferred candidate is selected. This may lead to additional concerns about the probity of the contract determination process. The Commission notes that the ACEA and the NSW Independent Commission Against Corruption (1995) have prepared guidelines aimed at addressing the probity concerns of QBS.

C6.4.2 Due diligence

A due diligence process generally refers to the verification of a company's true financial position (incorporating all assets and liabilities) pursuant to a takeover. In the context of CTC, a 'due diligence' process is necessary to ensure that the final offer is a complete assessment of the full range of issues which may influence the price, quality or other aspects of the provision of the service. For large and complex projects in particular, a due diligence process would appear beneficial.

The due diligence process is essentially a formalisation of 'checking' procedures that are likely to have been carried out in other stages of the process. It is necessary for the potential contractor — in terms of inspecting work sites, verifying access to government support systems or checking on other assets which will be transferred — as well as the contracting agency. The latter should use the due diligence process to ensure that the final bid is fully costed (including all relevant costs) and all relevant legal issues are addressed.

The South Australian Government guidelines formalise the due diligence process as a stand alone stage of the competitive tendering process. However, most other jurisdictions recommend that similar verification processes be employed during the general evaluation or risk assessment stages.

C6.5 Keeping participants informed

An important element of a successful competitive tendering process is the level of information given to participants. By keeping participants informed about the general progress of the tender process, as well as endeavouring to notify tenderers of the outcome of each successive tender stage, an agency can reduce the costs to potential bidders and to themselves.

The benefits of debriefing unsuccessful bidders appear to be widely recognised. For instance, the Commission heard a case where an engineering firm in South Australia was able to modify the safety characteristics of future bids in the light of a safety deficiency highlighted during the post-tender debriefing — a deficiency of which the firm had been unaware. Similarly, the South Australian Council of Social Service noted:

Bidders should be informed about the reasons that they were not successful and what elements of the successful bidders made its proposal superior. (Sub. 58, p. 10)

The benefits of information exchange extend beyond post-tender debriefing. For instance, Serco Australia (Sub. 144) said it preferred to tender for contracts let by agencies which sought clarification and further information during the

assessment phase, and kept tenderers briefed on their progress towards determining a successful bidder. Detailed debriefing following such a process also was welcomed. These benefits are also recognised by many contracting agencies, with box C6.4 outlining the approach followed by the City of Melbourne.

Box C6.4: The City of Melbourne approach

As with a number of participants, the City of Melbourne recognises the benefits that flow from keeping tender participants informed during the tender process. Each tender process is accompanied by briefing sessions, with sufficient time allocated between the release of the initial tender documentation and the first briefing session to generate written questions around the content of the documentation.

The City conducts a round of interviews after each major phase of the tender process. Short-listed tenderers are interviewed to ensure they have a clear understanding of the service requirements and the documentation released so far. Interviews also are held after the receipt of formal responses to the complete tender to assist the City's evaluation team gain an appreciation of the logic behind each bid.

Source: Makings 1995

In the context of keeping participants informed about the tender process, it is important that information relating to the treatment of transition costs (including redundancies) and other factors likely to influence a contractor's commercial decision whether to submit a tender are available in the tender documentation. Additionally, the Commission considers it desirable for unsuccessful tenderers to be advised in writing as soon as they are eliminated from the evaluation process. This approach minimises the scope for misinterpretation of comments and guards against different contractors being (inadvertently) given different types or quantities of information.

Participants should be kept informed during all stages of the tender process. Agencies should ensure that all participants are given equal opportunity to access this information.

C6.6 A framework for service tendering

The Commission recognises that, given the range of agencies and scope of services canvassed in this inquiry, a detailed 'how-to' manual of competitive tendering directives would not be appropriate. The Australian Association of Social Workers echoed this view:

It is both unhelpful and inappropriate to adopt a similar set of prescriptions and a common template for the market testing of all public services, regardless of fundamental differences in service content, technology and operating environment. (Sub. 23, p. 4)

Moreover, the Commission notes that many agencies and jurisdictions have already produced guidelines and regulations on competitive tendering for government services. For example, guidelines have been produced by the New South Wales, Victorian, Western Australian and South Australian Governments to assist their agencies (see chapter C2). Guidelines for some local governments have also been produced.

Notwithstanding this, the Commission considers there may be value in drawing together the key lessons to assist contracting agencies develop and implement appropriate tender processes and practices.

To an extent, the Code of Tendering (AS4120) produced by Standards Australia provides a basis for agencies to formulate an appropriate tender process. The Code of Tendering provides guidance on the obligations of the principal (proceeding through pre-tender stages, the actual tender and the evaluation of competing bids) and the obligations of the tenderer. Indeed, the Electrical Contractors' Association of Queensland noted:

The new code of tendering AS4120 offers fair and equitable tendering and outlines conduct and procedures that give a measure of protection to those tendering. (Sub. 182, p. 3)

The Code of Tendering provides a statement of ethics underlying best-practice tendering procedures. While it is primarily structured towards construction contracts, the Commission considers that the Code provides a useful guide for agencies and bidders generally.

Another useful document is the Code of Ethics and Procedures for the Selection of Consultants (AS4121) published by Standards Australia. It contains guidelines on the selection of external consultants in the construction industry.

Recommendation C6.1 identifies the key characteristics of a successful competitive tendering model based on the experiences documented throughout this chapter.

Recommendation C6.1

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 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.**

In their responses to the draft report, most participants considered that the points listed in recommendation C6.1 would be useful for those involved in the tender process. Most governments acknowledged that many of the points are already included in their tendering guidelines.

The Australian Council of Libraries and Information Services (Sub. 265, p. 4) commented that in applying ‘best practice’ guidelines, it needs to be recognised that the tender process will vary between agencies and activities. It noted that in the case of libraries, quality of service, equity, accessibility and client satisfaction are desired outcomes.

The Commission recognises that the precise tender process and contract type may need to vary on a case-by-case basis, based on the characteristics of the service and the nature of the contractual incentives and penalties required to achieve the desired outcome.

C6.7 Conclusion

Effective and efficient tender processes are central to realising the full benefits of CTC. Inappropriate or poorly implemented tendering practices can impose costs on agencies and prospective contractors, reducing the benefits of CTC.

In specifying service requirements, preparing contracts and developing and managing tender processes, agencies should take into consideration the relevant service, agency and market-specific characteristics, together with the ‘best practice’ guidelines outlined above. This will ensure that the tender processes adopted are appropriate to the individual circumstances of the agency and enhance the benefits to the agency, its clients and the community as a whole.

C7 QUALITY ASSURANCE AND PERFORMANCE MONITORING

C7.1 Introduction

Successful outcomes from CTC will largely depend on many aspects that have been discussed in earlier chapters. Those chapters also emphasised the importance of selecting and monitoring contractors to ensure that they deliver the outcomes sought.

This chapter will discuss the use of various mechanisms to ensure the ongoing performance of contractors and to minimise the risk of contract failure.

C7.2 Ensuring ongoing performance

Contract failure will occur when there is either a total breakdown of the contractual relationship (leading to early contract termination) or persistent under-performance relative to the agreed standards specified in the contract (Domberger 1994a).

As observed in chapter B1, it is up to the contractor to meet its obligations under the contract. The contracting agency is responsible for ensuring that an adequate quality assurance system is in place to enable the contractor to meet these obligations. There are two elements of risk that the agency has to address:

- do the contractors have the capacity to perform to the agreed standards; and
- are those standards then being attained?

The two main approaches to minimising contract failure are:

- the adoption of *quality assurance*, in its various forms, as a way of reducing the risk associated with inappropriate contractor selection; and
- the development of a *performance monitoring* regime to ensure that the specified standards are being attained.

The way these two approaches are used is highly interdependent in that the more comprehensive the quality assurance arrangements, the less will be the need for detailed performance monitoring.

This chapter examines the two approaches and evaluates their appropriateness.

C7.3 The risk and cost of contract failure

When deciding on an approach to ensure ongoing performance, the contracting agency should take into consideration:

- the risk and cost of failure; and
- the expense of the strategy adopted to reduce that risk and cost.

The risk of contract failure depends in part on the nature of the service. Chapter B2 identified the difficulties associated with ensuring quality outcomes with services where:

- specification of outcomes is made difficult because the future needs of individual clients cannot be predicted (eg in the case of aged care, disability services and emergency services); and
- there is no standard measure of the quality because quality depends on combining a number of elements of a service in different ways for different clients (eg with child care and prisoner management).

Where there are problems of specifying quality and in measuring outcomes, as occurs with many community welfare and emergency services (see chapter B2), it becomes more difficult to develop comprehensive and unambiguous performance specifications, making it hard to monitor and correct performance problems (Domberger 1994a). As a result, the risk of failing to meet the expectations of the client group increases.

The cost of failure varies for different services. For any failed contract there will be costs associated with re-tendering, legal costs and costs of compensating disaffected clients. For many health services, however, the cost associated with service failure may extend to the loss of life.

C7.4 Quality assurance strategies

Selection of a capable contractor is crucial to reduce the possibility of contract failure, particularly where the risk and cost of failure is high. Chapter C6 examined the use of pre-qualification requirements as a way of reducing the risk of contract failure. Such prequalification commonly incorporates quality assurance strategies.

The Commonwealth Department of Administrative Services (DAS) defined 'quality assurance' as:

The sum of all those planned and systematic actions that are measured and managed to give confidence that the end result will satisfy the user's requirements ... In contractual situations, quality assurance is the provision of satisfactory evidence by the supplier

that the good or service has been or will be produced consistently to customer requirements. (1992a, p. 3)

The use of various forms of quality assurance as a way to reduce the risk of contract failure was raised by many participants.

The Civil Contractors Federation, Western Australian branch, considered:

To gain the full economic advantage of 'Contracting Out' it is essential that the principles of 'Quality Assurance' should be implemented. (Sub. 77, p. 5)

There is a continuum of quality assurance strategies from which to choose. They include:

- an accreditation program for potential contractors developed by a contracting agency;
- third party certification of a 'quality system' (eg ISO 9000); and
- requiring contractors to provide evidence of appropriate internal management systems.

C7.4.1 Quality accreditation programs

A number of approaches have been tried to ensure service quality. Specifying (often in regulation) the inputs to be used in delivering the service and inspecting the outcome of the service against established performance criteria are two approaches. In an attempt to prevent quality failure rather than identify it after the event, some agencies have used the approach of *quality accreditation*. Quality accreditation seeks to pre-qualify individuals or organisations on the basis that they can meet expected service standards.

Under an accreditation program, the setting of service standards, the process for review against these standards and results of the review are formalised through an accreditation body. This body is normally independent of government, although often funded by government.

Examples of quality accreditation programs include:

- the Quality Improvement and Accreditation process developed for long day child-care. Child-care centres are accredited at a range of levels. The higher the level of accreditation, the longer the period of accreditation. Accreditation is undertaken by a national accreditation body using reviewers from the industry (Sub. 226);
- the *Employment Services Act 1991*, which requires the Employment Services Regulatory Authority (ESRA) to manage an accreditation scheme for case managers. Tenders for the provision of case management services

are only accepted from providers who have been accredited by ESRA (Sub. 139); and

- the Australian Council of Healthcare Standards (ACHS) has developed an accreditation program for hospitals and associated health services. This is both a benchmarking exercise and a performance measurement tool, allowing the Department of Human Services and Health to be satisfied that hospitals with ACHS accreditation meet a national standard in terms of quality of care (Repatriation Commission/Department of Veterans' Affairs, Sub. 110).

Quality initiatives such as these appear to be becoming more common in the health and community welfare sector, where the risk and cost of failure are potentially high. Proponents of accreditation programs argue that they provide scope not only to focus on the process involved in service delivery, but also to assess the outcomes of service delivery.

While such an approach to ensuring service delivery may reduce the risk of contract failure, it can have unintended consequences. If the various elements of accreditation are too prescriptive, for example, with regard to the qualifications of people providing services, they can add to costs significantly without comparable improvements in service quality.

Apart from introducing barriers to entry that may excessively reduce the amount of competition and impose costs on potential service providers, the contracting agency can incur substantial costs in the administration of an accreditation program — in particular the high costs involved in carrying out detailed inspections of contractors.

C7.4.2 Quality system certification

Another increasingly common approach to minimising the risk of contract failure and retaining some control over the quality of services delivered is to require potential contractors to have a certified quality management system in place (see box C7.1).

A quality management system involves a formal procedure in which the internal processes central to the delivery of a product or service are defined, documented and continuously improved. It is not the purpose of a quality management system to guarantee the quality of the final product or service, but rather to provide management and employees of the contractor with greater control over the production process to achieve consistency in meeting clients' needs, and addressing the causes of poor quality when it is identified (Kean 1995).

Box C7.1: Key objectives of a quality management system

The key objectives of a quality management system are to:

- achieve a focus on quality of products and services for the customer;
- manage the systems and processes people use;
- measure the cost of waste/repairs;
- develop a culture of continuous improvement;
- formalise (write down) what is done to achieve the products and services (eg quality assurance manual);
- provide evidence that the right things have been well done; and
- provide records for measuring waste, repair and re-use.

Source: Schubert 1994

Tenderers are able to achieve certification after they have successfully developed and implemented a quality management system and have the system audited against appropriate standards.

In Australia the common quality management standard to which organisations aim to achieve certification is the AS 9000 series of standards (previously known as AS 3900) developed by the Standards Association of Australia as the Australian equivalent to the international standard ISO 9000. To gain certification to AS 9000, an organisation is required to be audited by an independent certification body accredited by the Joint Accreditations Systems of Australia and New Zealand (Standards Australia 1994b). There has been a significant drive by all levels of government to use certification to the AS 9000 series as a prerequisite in the procurement of both goods and services.

Achieving certification for quality assurance standards, such as AS 9000, assures the adequacy of the contractor's internal systems. But, unlike a quality accreditation program, this approach does not attempt to define quality standards to meet the requirements of individual customers.

Compared with quality accreditation, the value of quality system certification is that:

- service providers are able to gain from greater management control of their service delivery processes;
- it is not necessary for the contracting agency to determine the processes involved in service delivery, avoiding potential barriers to innovation; and
- it is likely to be more cost-effective than mandating service standards and inspecting to ensure that they are attained.

The *Report of the Committee of Inquiry into Australia's Standards and Conformance Infrastructure* (Kean 1995) identified a number of benefits for organisations from obtaining certification of a quality management system. In particular, it found that organisations can acquire a competitive edge over non-certified competitors; improve access to domestic markets and customer satisfaction; and achieve reductions in goods handling, operating expenses, absenteeism and injuries (p. 135).

DAS spoke highly of quality system certification:

Experience within DAS indicates that the quality certification process itself is a powerful force for organisational reform, by requiring the identification and documentation of processes used by the business, use of benchmarking and industry best practice and a process of continuous improvement. (Sub. 140, p. 19)

Indeed, both the Australian Manufacturing Workers' Union and the Australian Liquor, Hospitality & Miscellaneous Workers Union (LHMU) recommended that quality accreditation and quality system certification be mandatory. In the view of the LHMU:

... the introduction of these provisions is part of International Best Practice and therefore is something that should be required of all contractors. A contractor gaining such accreditation has clearly shown that it has a commitment to business and providing the best services available. (Sub. 245, p. 2)

However, the benefits associated with acquiring this certification may come at a significant cost. In particular, the cost of formal certification is seen to be prohibitive for small businesses. The Small Business Development Corporation of Western Australia argued:

... public agencies need to understand the cost implications for small business of quality assurance generally, and not preclude large numbers of firms from bidding by setting unnecessarily restrictive certification requirements. In many instances the normal market place standard will be acceptable for service delivery, without quality assurance requirements. (Sub. 103, p. 5)

The Commission's report on *Charitable Organisations in Australia* identified that it would cost small enterprises around \$10 000 to \$15 000 in external audits to help them put in place the processes required to obtain and maintain certification. The Commission went on to say that these enterprises also face an internal cost in realigning their internal structures and that these costs are more difficult to predict (1995d).

In this context, a recent survey of Australian companies found that the average cost to implement ISO 9000 and gain certification was around \$55 000 for small organisations, around \$115 000 for medium organisations and in excess of \$200 000 for large organisations (O'Brien 1995).

In recognition of the costs associated with obtaining certification, the Kean Report stated:

The Committee is of the view that, especially in view of its high cost, discretion should be exercised in requiring QMS [Quality Management System] certification, especially when quality assurance can be achieved in many instances without a formal quality management system. (1995, p. 138)

The balance between the costs and benefits of quality system certification is likely to vary from case to case. As it is a question essentially of the magnitude of the risk involved, it seems quite inappropriate to require certification for all contracted services. Reflecting this, the Commonwealth's Quality Assurance Policy states:

The Commonwealth recognises the need to exercise quality assurance requirements selectively. The applicability of quality standards to individual transactions is a question of net benefit to the Commonwealth, determined by the buyer through informed decisions about the intended role of the good or service and the likely consequence of failure and/or non-compliance. (DAS 1992a, p. 9)

It is the role of the contracting agency to assess the risk and cost of contract failure. Where either is seen to be high, quality system certification will provide some assurance that the contractor has in place (and understands) the processes required to deliver the service effectively. As such, while imposing costs on the contractor, quality system certification could be used to reduce the risk of selecting an inappropriate contractor.

C7.4.3 Internal management systems

While the use of externally audited quality assurance strategies such as an accreditation program or quality system certification is not appropriate in all instances, the contracting agency should require, as a minimum, some evidence of ongoing management capability where there is going to be an ongoing relationship. Indeed, under the Commonwealth's quality assurance policy, tenderers can obtain appropriate assurance of quality through such means as normal commercial practices for less critical purchases, rather than obtaining accreditation or certification.

The contractor can demonstrate 'good management practice' in a variety of ways. For instance, the contracting agency may give some weighting in selection to organisations that have appropriate financial systems, suitable human resource management practices (including training, recruitment and payroll practices), customer service systems and so on.

The appropriateness of a particular management system will depend on the nature of the service. In general, the contractor is in the best position to determine the appropriateness of different internal management systems for its organisation. Where a contractor has chosen to adopt a particular management system, this is because it expects to internalise its benefits. Potential service providers should be encouraged to compete on the basis of providing evidence of having adopted appropriate internal management systems.

C7.4.4 Choosing a quality assurance strategy

Issues concerning formal quality certification and internal management systems were also addressed in the Kean Report (1995). The Commission supports the general approach to quality assurance requirements adopted in that inquiry (see box C7.2).

Box C7.2: Quality assurance requirements — the Kean Report

Recommendation 36 of the Kean Report said:

The Australian Quality Council, in conjunction with government purchasing authorities and the Wider Quality Movement, develop and promote a three-tier approach for applying quality assurance requirements in purchasing along the following lines:

- for low value, low risk purchases — self attestation;
- when dealing with a known supplier — acceptance of a good performance record in the past; and
- for high value or high risk purchases — a combination of certification to a product standard and/or ISO 9000 certification as appropriate.

Source: Kean 1995, pp. 139-40.

In response the Commonwealth Government recently provided:

Qualified support for the recommendation, recognising that the three-tiered approach recommended by the Committee failed to gain acceptance and noting the work already underway by Purchasing Australia towards implementing a five-tiered approach to quality assurance in purchasing. (Department of Industry, Science & Technology 1995)

Recommendation C7.1

Agencies should ensure that successful tenderers have in place appropriate quality assurance systems. The systems chosen should be kept as simple and inexpensive as possible. Quality accreditation and quality systems certification should be required only where the risk and cost of quality failure is high. In other cases, a good performance record and/or evidence of appropriate internal management systems will be appropriate.

C7.5 Performance monitoring regimes

Monitoring is a central aspect of contract management. It is the process by which an agency oversees the contractor's performance to be sure the contractor meets the performance standards specified in the contract. As Reh fuss said:

Monitoring is the chief means of safeguarding against contracting problems once the contract is signed and of ensuring that citizens are obtaining high quality services at competitive prices. (1993, p. 1)

Regardless of the quality assurance strategy adopted, monitoring is required to ensure that the service is being delivered effectively once the contract is in place. In the absence of monitoring, there is no way of knowing whether the contractor's work is faithful to the contract terms or whether clients and the contracting agency are satisfied with the service.

The importance of monitoring to secure the performance expected of a contractor was emphasised by the NSW Premier's Department:

A crucial requirement for successful contracting, be it in-house or external, is effective monitoring of performance. The benefits generated are significant in terms of encouraging improved performance; assisting in future design of specifications and contracts; and ensuring the terms and spirit of the contract are adhered to, including the commitment to service quality. (Sub. 199, p. 6)

Ongoing monitoring is an important aspect of identifying any difficulties or differences in expectations early so that corrective action can be taken, particularly where there are:

- ongoing relationships (as in the delivery of services);
- difficulties in measuring and specifying the required performance;
- potentially high legal costs of contractual dispute; and
- potentially high costs if there is a disruption in supply.

There are a number of approaches to performance monitoring, including the use of performance indicators, the use of regular contractor reports on outcomes, customer surveys and direct inspection.

C7.5.1 Performance indicators

The development of performance indicators and their incorporation into contracts is a valuable method of ensuring objective assessment of contractor performance. Performance indicators have been defined by Hall and Rimmer as being:

... quantitative and qualitative statistical information which is used to assist in determining how successful an organisation is in achieving its objective. (1994, p. 456)

Performance indicators can be used in contract management to:

- specify the performance expected of the contractor;
- measure the performance of contractors; and
- define continuous improvements required (eg through benchmarking).

The importance of developing performance indicators was emphasised by the contractor, Skilled Engineering:

In order to ensure ongoing cost savings and performance efficiency many clients who have contracted out work have used Management Fee contracts with Key Performance Indicators to support their contractors. Key Performance Indicators mutually negotiated between the parties are designed to ensure the contractor focuses on the key business drivers of the client and in this way support the client fully. The raising of performance standards as each level is progressively reached ensures on going performance improvement by the contractor. (Sub. 69, p. 10)

While different types of services will generally involve a different set of indicators, there are a number of principles that can be applied for the development of suitable indicators to monitor contractor performance. Hall and Rimmer (1994) identified the most important characteristics of the set of performance indicators selected as being that:

- they reflect client demands and cover key elements of contractor performance (cost, level of output, quality of output etc);
- they are cost-effective to collect, providing adequate data at reasonable cost;
- they are practical to implement, providing consistently reliable data;
- they match the objectives of the contracting agency and their suitability is formally agreed to by the contractor;
- they avoid distorting the service provided;

- there is a sufficient range of performance indicators developed to avoid misinterpretation of the results (reliance on single performance indicators can provide misleading information); and
- a collection mechanism is designed to give adequate protection to commercially sensitive data.

The difference between efficiency and effectiveness, outputs and outcomes

As discussed in section B1.3, responsibility for translating broad program objectives into service specifications and ensuring that the contractor fulfils them resides with the contracting agency. To do this the contracting agency needs information on performance — information on both the *efficiency* and the *effectiveness* of the service.

Efficiency refers to how well resources are used to produce services. The key measure of efficiency is the cost per unit of service.

Effectiveness refers to how well the outputs of a service achieve the stated objectives (outcomes) of that service.

In assessing effectiveness it is necessary to distinguish between *outputs* and *outcomes*. While outputs are the volume of service received by clients in terms of a completed service, outcomes are the measurable changes to the quality of life of the recipients of the service (Kettner and Martin 1993). The quality of the service and the extent to which clients are able to access the service are two important aspect of effectiveness. Monitoring devices such as client complaints and surveys designed by an individual agency can assist in measuring how well the service meets the needs of the client.

Performance indicators and accountability

Besides their use in contract management, performance indicators are starting to be developed and published more widely in the community. This enables the performance of government services to be opened to greater public scrutiny and enhances accountability (see section B1.3.1).

In December 1995 the Steering Committee for the Review of Commonwealth/State Service Provision (1995) published its first annual report, covering a range of services including public housing, government school education, corrective services and public acute care hospitals. Box C7.3 outlines the types of effectiveness and efficiency indicators being adopted for public hospitals.

Box C7.3: Performance measures for hospitals

A set of effectiveness and efficiency performance indicators for public hospitals in Australia have recently been published.

Effectiveness measures include:

- unplanned hospital readmission rates
- unplanned return to theatre
- hospital acquired infection rates
- % of beds with ACHS accreditation
- waiting time for access to outpatient services
- waiting time for elective surgery
- accident and emergency waiting times
- patient satisfaction

Efficiency measures include:

- cost per outpatient occasion of service
- total cost per diagnoses related group
- labour cost per diagnoses related group
- capital cost per diagnoses related group
- average length of stay

Sources: Steering Committee for the Review of Commonwealth and State Service Provision 1995

C7.5.2 Client complaints and surveys

The importance of a client complaints mechanism as a means of ensuring service quality was raised in chapter B2.

The use of a complaints mechanism can be an effective method of ensuring that the contractor is meeting the specified standards. It can be a low cost way of gaining feedback from clients of a service on the performance of the contractor. Where it is difficult to specify and measure outputs, a complaints mechanism is a particularly useful monitoring device. However, to be effective it is essential that there is an identifiable and accessible contact for clients. As suggested by the Hobart City Council:

To a large extent contracting out services will only be as successful as the organisation is in establishing and monitoring customer complaints, conducting consultation processes, and undertaking attitudinal surveys and the like. (Sub. 153, p. 12)

Comments and complaints made direct to the contractors provide them with an opportunity to address the problem directly. Generally quality assurance processes incorporate customer comments and complaint mechanisms.

The number of complaints received can also be used as a key performance indicator. However, a contractor's performance should not be assessed on complaints alone. The contracting agency should be more concerned with whether the complaints have been satisfactorily addressed and within a reasonable timeframe.

Another way of determining client satisfaction with a contractor is to undertake client surveys, as a number of agencies have done. Some examples are given in box C7.4.

Box C7.4: Examples of client surveys

At the Surf Coast Shire (Vic) any service contracted, either to an in-house team or externally, must meet client satisfaction standards. These standards can be obtained by market survey prior to contracting and also market survey within the timeframe of the contract.

As part of the contracting of public sector IT services the South Australian Government has instructed the Office of Information Technology to undertake an annual client satisfaction survey.

The Department of Veterans' Affairs (DVA) conducts surveys, such as the Client and Carer Survey, to allow patients to raise concerns about their health care. Monitoring committees of veterans are also used to provide patient feedback.

The Defence Housing Authority, which has contracted out the maintenance of housing, conducts regular mail surveys of tenant satisfaction with maintenance received. On the basis of a random selection from the Works Orders that authorise maintenance to be performed, tenants are surveyed to assess the quality of work conducted as well as the courtesy and efficiency of the Authority when approached for service, and the general demeanour of the contractor in matters of courtesy, punctuality and cleanliness.

Sources: Subs. 4, 123, 110 and 112

Client surveys conducted by the contracting agency can be particularly useful for those services where it is difficult to specify and measure the quality of the service provided. The client is able to provide feedback on all aspects of the service delivered, providing an opportunity for continuous improvement. The contracting agency can also use such surveys to assess the outcomes of the service — whether the service in question is meeting its policy objectives.

However, survey results need to be carefully interpreted. The South Australian Council of Social Services (SACOSS) stated:

... the results of satisfaction surveys need to be treated with a degree of caution, as do other mechanisms for establishing consumer satisfaction with services. In the aged care field, surveys often reveal a high level of satisfaction. However, this seems to be a combination of the desire of people not to appear to be "ungrateful" to those who are assisting them and a fear that, even though the survey is anonymous, the respondent may lose the service they are receiving. (Sub. 58, p. 4)

SACOSS went on to argue that more accurate results are achieved when a 'high level of trust develops' between the contractor and the clients (Sub. 58, p. 4).

C7.5.3 Contractor reports

Contractor reports are contractor-generated statements of progress. Such reports typically provide an update of the work completed, an assessment of how the service delivered compares with the contract requirements, performance in relation to established performance indicators, a comparison of work with the previous period and a detailed explanation of costs incurred. These reports provide a basis for ongoing dialogue between the contractors and contracting agencies. The Civil Contractors Federation considered such reports to be:

... the normal means by which a contractor certifies that the service is meeting specifications of the contract and reports progress to date, identifies problems in providing the service, and explanation of costs. (Sub. 53, addendum 3, p. 69)

In general, such reports should be used in conjunction with other methods of monitoring. Given that they are prepared by the contractor, rather than an independent body, the contracting agency should ensure that the reports are carefully reviewed and compare the information obtained from other forms of monitoring.

C7.5.4 Inspections

For functions contracted where the risk and cost of contract failure is very high, direct inspections may be deemed necessary. They should be considered where other performance monitoring methods cannot give sufficient guarantee of the desired outcome. Activities such as garbage collection may not require inspection because poor performance will trigger client complaint. However, councils may still consider doing spot checks. Services such as nursing home care, however, may require surprise inspections, whereas those contracts that involve capital equipment may require periodic inspection. Whatever inspection is considered necessary, the inspector should assess performance according to predetermined objective criteria to avoid arbitrary action.

Direct inspections can, however, consume a lot of resources. Where they are deemed essential, the contracting agency should examine the most cost-effective way of undertaking them. The agency need not undertake the inspection itself. Such activities are increasingly being contracted to independent third parties. Building inspection is one example of where inspection, once performed by a government agency to determine the quality of product, has been contracted to expert third parties.

C7.5.5 Choosing a performance monitoring regime

The method of monitoring will depend on the service in question. For those services where it is particularly difficult to monitor outcomes, a number of monitoring methods may need to be combined. Box C7.5 provides an example of how different monitoring regimes have been combined for residential aged care.

Box C7.5: Service standards for nursing homes and hostels

The key performance measurement tool for nursing homes and hostels is the Outcome Standards Program.

This program measures the quality of service delivery against benchmarks for quality of care and quality of life. The benchmarks are based on 31 client outcome standards grouped into seven categories including: health care; social independence; freedom of choice; homelike environment; privacy and dignity; variety of experience; and safety.

Individual providers' performance against the Outcome Standards is monitored by a process of planned visits by Standards Monitoring Teams. Visits are scheduled using a risk management strategy designed to target intervention at those facilities assessed as being at higher risk of poor performance (through complaints and other indicators), while ensuring some regular monitoring for all. Standards Monitoring Teams include clerical and nursing staff. The process includes opportunities for input from the provider and review processes where there are adverse findings.

Following the development of outcome standards for nursing homes and hostels, mechanisms were introduced to give greater rights to service users as a means of ensuring quality. They included the development of a charter of residents' rights and responsibilities.

Source: Department of Human Services and Health Sub. 226, p. 14

Overall, the Commission considers the effective monitoring of contractors' performance to be a key element in successful CTC. But it is not costless and agencies should avoid excessive monitoring, as this will reduce the benefits associated with improved efficiency and innovation. Cost-effective methods, such as surveys and spot checks, should be considered.

C7.6 Conclusion

Contracting agencies need to determine the most cost-effective approach to ensuring the quality of service delivery. The preferred monitoring regime should be decided in conjunction with the quality assurance strategy that is to be used. The higher the risk or cost associated with contract failure, the more appropriate

it becomes for the contracting agency to introduce the more costly quality assurance and monitoring techniques.

C8 HUMAN RESOURCE MANAGEMENT

C8.1 Introduction

The success of competitive tendering and contracting (CTC) is heavily influenced by the manner in which government agencies manage their employees. Chapter B4 analysed the effects of CTC on employment and the wages and conditions of public sector employees. This chapter examines certain key aspects of managing human resources during the CTC process, namely:

- the cultural change to CTC;
- skills acquisition; and
- handling excess staff.

C8.2 Managing cultural change

The CTC process often entails a fundamental change in some of the functions of government agencies. Where service delivery and regulation may have previously been the major function of government agencies, a move to CTC changes the agency focus towards being a purchaser of services.

In many cases, CTC has involved significant work restructuring, job respecification, training and changes to work practices. CTC has frequently also been coupled with other reforms such as council amalgamations and the introduction of enterprise bargaining. These reforms have often led to substantial reorganisation and necessitated major cultural change.

The City of Melbourne cited as one of the imperatives for public sector agencies wishing to guarantee tangible benefits from CTC:

Accelerating the rate of internal reform and embracing a corporate culture based on competitive ethos and customer service. (Sub. 89, p. 23)

Indeed, changing the culture of government organisations was viewed by some participants as one of the major advantages of embarking on CTC. For example, the South Australian Council of Social Service (SACOSS) argued:

There are a range of reasons for Governments to consider the contracting out of services previously provided by Government. One of these is as a means to reform bureaucratic work organisation and a bureaucratic work culture. ... [CTC] promotes internal reorganisation and a change in culture to a focus on output/outcomes for customers rather than on the detailed mechanics of service delivery. (Sub. 58, p. 7)

Several participants commented on the change in culture that had occurred in their organisations as a result of the move to CTC. For example, Hobart City Council stated:

A strong customer focus in the delivery of services has emerged, in lieu of the traditional perception of local government as a regulator. In addition, significant effort has been expended to promote a competitive culture in the delivery of services, in anticipation of future benchmarking with other external organisations through market testing. (Sub. 153, p. 4)

And in the Shire of Swan (WA):

Council is altering its organisational structure and work processes to implement these changes so that strategies are put in place to change the culture of the organisation to make all its operations more effective and competitive. (Sub. 158, p. 2)

In some cases, external pressures may provide added impetus for cultural change. For example, the Municipal Association of Victoria considered that “community awareness of the change process and the achievements by councils is integral to sustaining real cultural change” (Sub. 302, p. 4).

Cultural change is not easy to achieve, particularly where poor management and work practices have become entrenched in an organisation. The following sections consider the importance of management commitment and early and open communication with staff and their representatives in making the transition to CTC.

C8.2.1 Management commitment

Effective management is crucial to the success of CTC. Chapter B4 identified that CTC may result in a reduction in employment within government agencies, particularly where there is a transfer of activities outside the organisation. As a result employees may move to the contractor, be redeployed, or be made redundant. The disruption caused by CTC may be unsettling for the organisation, its employees and their families.

Even for those employees who remain in the organisation, internal restructuring and reorganisation is likely to be disquieting. However, if managed well, it can also instil a cultural change that may induce greater productivity gains. For example, a case study examining the tendering of cleaning in three New South Wales hospitals identified improvements in staff morale as an unexpected benefit (Hall and Domberger 1995).

The Association of Professional Engineers, Scientists and Managers, Australia (Sub. 61) identified some of the varying concerns for employees facing CTC. For example, employees remaining with the public sector agency will be concerned about new career structures, changed career horizons, retraining

opportunities and work redesign. Employees displaced as a result of CTC will be concerned about departure packages, the availability of outplacement services, opportunities for re-employment and adequate notice of the change. Employees transferring to the contractor will be interested in any changes to wages and employment conditions, contract employment and career opportunities.

The experience of agencies which have undertaken CTC suggests that one of the most powerful forces driving change has been the commitment of chief executive officers (CEOs) to the process. For example, the CEO of the District Council of Clare (SA) was seen as responsible for driving many of the reforms in that organisation, including the introduction of CTC:

In 1987, the council undertook a major structural and operational reorganisation, initiated mainly by a newly-employed CEO. Early public reaction to the CEO was positive. A local newspaper report in late 1987 referred to him as 'youthful and quick-thinking', 'our CEO dynamo', someone who 'inspires confidence and urges people to perform to the best of their ability', and someone who 'doesn't interfere but genuinely supports'. According to an ex-councillor, who was an elected member at the time of the appointment "[The new CEO] had a lot of vision. Within a short time of his appointment, he spent a weekend with us to work out a five-year and a ten-year plan. Up until then, our council had never done any planning whatsoever." (Domberger and Hall 1995, p. 94)

Participants emphasised the commitment of management in being able to handle the transition. For example, Manningham City Council (Vic) (Sub. 172) argued that management commitment is a key feature in achieving effective CTC. Hobart City Council (Sub. 153) also suggested that the move towards a competitive structure and culture as a result of CTC has been driven largely by more committed and professional management.

There are a number of ways in which management can seek to develop the commitment of staff. For example, agencies have:

- held information sessions about how CTC will affect the organisation and the staff;
- invited suggestions from staff on how best to implement the process;
- kept staff well informed through regular meetings and newsletters; and
- provided staff with information and services to assist their transition, including advice on taxation and financial matters.

Some participants indicated that management made a significant effort to provide staff with the necessary support and services in order to deal with the transition to CTC. For example, Skilled Engineering (Sub. 69) provided support services to the workforce in the Latrobe Valley Maintenance Services area over a two-year period in order to change attitudes and practices (see box C8.1).

Box C8.1: Skilled Engineering human resource support services

As part of the program of outsourcing 2200 jobs at the Latrobe Valley Maintenance Services area, Skilled Engineering provided incoming staff with comprehensive services in the areas of engineering and technical work, accounting and evaluation analysis, human resource support services and industrial advice, business analysis and negotiation skills.

The human support services included:

- workshops and counselling on issues relating to the impacts on careers, lifestyle and family;
- money management seminars dealing with day-to-day money management, debt, pension benefits, roll overs and investment advice;
- career options and preparation for new jobs, such as resume writing skills and career planning advice; and
- small business training targeted at employees interested in pursuing employee/management buyout options or the purchase of a small business.

In many cases, local support services such as job search centres and vocational and non-vocational training centres were also used.

Source: Skilled Engineering (Sub. 69)

These strategies often provide a cost-effective means of managing the potential disruption caused by a fundamental change in an agency. Not only do they assist those employees who may be affected by the CTC decision, but they also demonstrate to other staff that management is concerned about human resource issues and the impact on employees.

The experience of government agencies that have successfully dealt with the many human resource issues involved in CTC indicates that the full commitment of the CEO and senior management to the whole process is essential.

C8.2.2 Communication with staff and their representatives

Early and open communication was identified by many participants as a key feature of successfully managing the CTC process. The City of Melbourne commented:

Throughout most of its reform initiatives, the Council has also ensured that the staff are provided with the opportunity to actively participate and lead these initiatives. This process of 'bringing the staff along' has paid considerable dividends to the Council

through increased awareness and professionalism of staff and the emergence of a corporate culture centred on customer service. (Sub. 89, p. 2)

Consultation should take place with staff and their representatives, such as unions and workplace established committees. Open consultation is essential to obtaining the cooperation and commitment of staff. The Department of Defence stated:

... we need the full and effective involvement of staff and their industrial organisations as part of the in-house consultation and bidding process — remembering this is a very major change initiative in Defence. We can't have and we can't live with a situation that doesn't allow open consultation. (Transcript, p. 582)

Best Practice also argued:

Where employees understand why things are happening and have confidence in the workforce planning parameters that may impact [on] them change is easier to accept — even if the parameters and outcomes are not personally accepted by the individual employee. (Sub. 26, p. 16)

In supporting full consultation with staff, the NSW Premier's Department distinguished between that and having staff involved in decision-making:

Before proceeding with any contracting arrangement, it is important for management to fully consult with staff. Consultation does not imply employee involvement in decision making or staff having a veto power. Accountability for the ultimate decision rests with chief executives but management should provide staff every opportunity to have a real input. (Sub. 199, p. 4)

Early consultation with staff and their representatives about employment opportunities appears to be an important factor influencing their ability to achieve a successful employment outcome. Wooden (1987), for example, identified that the probability of job search success for workers made redundant was positively associated with an early start to job search.

The outsourcing of the National Computing Centre by the Department of Veterans' Affairs (DVA) illustrated a consequence of not providing early and effective communication with staff and their representatives. Staff were not fully aware and were reportedly given misleading advice of entitlements (Auditor-General 1992b). This created a great deal of confusion, and contributed to all staff seeking redeployment and redundancy, rather than transferring to the contractor on the terms negotiated between DVA and the service provider. Early and effective communication with staff about employment options may have improved their ability to make informed choices about their future.

A lack of communication and integration of staff in the CTC process can also contribute to lower morale and dissatisfaction in the workplace, with serious repercussions for those employees who remain in the organisation after CTC.

The Australian Liquor, Hospitality and Miscellaneous Workers Union (LHMU), WA branch (Sub. 283) cited various cases where it claimed that the governmental authority undertaking CTC did not properly communicate to workers the agreed terms and conditions of transfer to the contractor.

Whilst open communication may assist in managing the change to CTC, it will not guarantee the smoothness of the transition. For example, in the sale of repatriation hospitals by the DVA:

We knew that while most staff would be angry they would also act professionally, especially if they are treated honestly, fairly and with dignity. Maintaining morale and productivity was an important component of the HR strategy. Finally, we expected that a few would do the wrong thing and had to be able to deal with the unexpected. (Lyon 1995, p. 8)

The experience of government agencies in dealing with human resource issues indicates the potential benefits of early and open consultation and communication with staff and their representatives, including unions. They should be given information, in particular, on the intention to introduce CTC, the process and timing that will be followed, employment opportunities and entitlements for staff.

C8.3 Getting the right skills

C8.3.1 Existing skills in government

If government agencies are to achieve significant efficiency gains through CTC, it is essential that they have, or have access to, the skills needed to effectively prepare for and manage the CTC process. Skills in assessing the scope for CTC, contract specification, negotiation, tender evaluation, contract management and performance evaluation will all be needed, as will the capacity to prepare in-house bids, where they are to be made.

The Australian Law Reform Commission commented that CTC changes the mix of staff employed:

My experience is that to maintain quality of service through arms length contracting one needs better skilled and more experienced staff to monitor the contractors performance and to administer contract detail. (Sub. 64, p. 3)

The Tasmanian Government acknowledged the need for different skills in relation to CTC:

Government itself has recognised that it too must develop a new range of skills focused on project and contract management. These skills not only include changes in the agency's attitude to the provision of technical services, but also require the acquisition

of new skills, such as an understanding of contract and trade practices law. ... This process has required many of the larger agencies to establish specialist sections to manage the contracting process. It has also caused problems for smaller agencies where there are substantial problems in establishing a group with the requisite skills to manage contracting out, while at the same time meeting the budgetary constraints that have often been externally imposed on their activities. (Sub. 108, pp. 3-4)

A number of participants highlighted the current lack of relevant skills in many government agencies. For example, the Hobart City Council observed:

Many Councils are simply throwing employees in at the deep end, and undoubtedly there are going to be some classic disasters to the significant cost of the community. ... success is going to be ultimately dependent upon the quality of the personnel performing the client and provider roles, and particularly the former. At the present time it is submitted the skills and experience in contract administration, and purchase of services is significantly deficient. (Sub. 153, pp. 8,11)

Where government agencies do not have or cannot obtain the skills to handle CTC, service effectiveness and the potential savings from CTC will be diminished. The NSW Premier's Department warned:

... a lack of skills in negotiation and implementation can lead to failure to realise the intended results of contracting and can have an adverse impact on the rational use of contracting in general. (Sub. 199, p. 3)

The CTC process requires a different set of skills than those traditionally held by many government agencies — particularly in contract specification, negotiation, tender evaluation, contract management and performance evaluation. Having access to the right mix of skills in government agencies is vital to maximising the gains from CTC. Some government agencies may not currently have the necessary skills to manage the CTC process effectively.

C8.3.2 Improving the level of skills and experience

Where agencies consider that they are inexperienced or do not have sufficient skills in-house to introduce and manage the CTC process, there are a number of strategies which may be used. These are discussed briefly below.

Training and information

Training and information on best practice can assist organisations to introduce CTC effectively. A number of agencies and local government associations have developed manuals and information kits to assist in the transition to, and management of, CTC (see chapter C2) including:

- the Department of Defence;

- Purchasing Australia (Commonwealth Department of Administrative Services);
- the State Supply Commission of Western Australia;
- Queensland Local Government Association;
- the Municipal Association of Victoria (MAV);
- the Local Government Industry Working Party (Victoria); and
- the City of Knox (Vic).

Case studies documenting the experiences of private and public sector organisations which have engaged in CTC also provide useful guidance. *The Contracting Casebook* (Domberger and Hall 1995) is a notable example. It reflects some of the recent CTC experience in Australia, drawing on the successes and failures of a number of agencies.

Numerous training courses, conferences and seminars have emerged in recent years, reflecting growing adoption of CTC. The MAV explained how it has been playing an active role in preparing local governments to operate in a compulsory competitive tendering (CCT) environment:

This has included the publication of a series of documents to assist councils with identifying services for tender, establishing a CCT policy and strategy, writing tender specifications, establishing business units, and developing a costing framework. The MAV has also undertaken an extensive training program for Commissioners, Chief Executives, Managers and council officers to provide them with the necessary skills to operate in a competitive environment. (Sub. 151, p. 2)

The Commonwealth Department of Administrative Services (DAS) offers a range of courses which provide advice and guidance on procurement which have been attended by State and local government officials (see box C8.2).

In addition, the National Supply Group, comprising Commonwealth and State representatives, meets regularly to share experiences and ideas in relation to procurement activity. However, DAS argued that there is no structured approach to working with local governments in this forum (Transcript, p. 1349).

These publications, courses and other educational material are a valuable resource for increasing the awareness of CTC issues and assisting agencies develop the skills required. They seem to be widely used by government agencies throughout Australia.

Box C8.2: DAS training courses

In 1990, DAS established the Purchasing Development Centre to offer courses based on extensive purchasing training needs analysis. Training courses recently developed include:

- the Statement of Competency *Basic Purchasing* for purchasing staff involved in basic level purchasing.
- the Certificate Level IV (previously Advanced Certificate TAFE) in *Public Sector Procurement* for staff involved in intermediate level procurement; and
- a university level course in *Advanced Public Sector Procurement*: a 'first' in the public sector for officers engaged in high risk and complex procurement, including a special module on contracting out.

To maximise flexibility, the course modules are small and can be adapted to be agency specific. Officers may be assessed in the workplace against those elements of the standards needed for their particular job and, if deemed competent, be granted a credential without undertaking any further training. Alternatively, if further training is needed, they need only access the particular modules necessary to meet their specific competency need.

Pilot courses will commence for the basic level training shortly, and work has commenced to translate this into a computer aided learning mode. The basic level course will be available in late 1995 and the intermediate and advanced level courses in 1996.

Source: DAS (Sub. 140, p. 39)

Recruitment and skills transfer

Another way to overcome the inexperience of government agencies is to draw on the skills of experienced individuals and organisations outside the agency.

Many agencies, particularly in local government, have sought to recruit managers or engage external consultants who have had experience in the introduction and management of CTC in other organisations, including in the private sector.

A complicating factor may be that remuneration packages available in the public sector are inadequate or too inflexible to attract people with the requisite skills. Where additional expenses are incurred in obtaining the required skills and experience to conduct the CTC process, this would need to be taken into account as one of the costs of CTC. This point was emphasised by the Australian Council of Social Service (Sub. 310, p. 16).

Also relevant to addressing the problem of skills is the Commission's recommendation in chapter C6 that agencies consult widely when developing service specifications. This would help to ensure that there is adequate input of

the right sort of knowledge and expertise, and assist in addressing any skills shortage within the internal provider.

Some agencies have tried to get around the problem of inadequate skills by placing their employees with contractors. For example, the Department of Defence (Sub. 81) stated that in some instances services personnel have been placed with contractor organisations.

The Australian National Audit Office (ANAO) indicated that it uses a number of strategies in introducing contracting into the organisation:

... new contracts would only be let for twelve months. For professional development purposes, the ANAO would seek to integrate, where possible, ANAO staff in contract work. Further, those contracts would not be let for a period in excess of three years. With core Government organisation financial statement audits, the ANAO seeks to use suitably qualified and experienced ANAO officers. For peak work loads, the ANAO would, where cost efficient, prefer temporary transfers of its own staff to engagement of temporary contract staff. In relation to GTEs [Government Trading Enterprises] it was agreed that all new contracts would include a provision for the involvement of ANAO staff. (Sub. 107, p. 4)

Agencies also need to be aware that, when activities are contracted out, it will be more difficult for them to develop internally the expertise necessary to specify services, evaluate bids and supervise contractors. Unless the agency has in-house providers, this source of internal training is lost.

The NSW Premier's Department commented:

The issue of skill retention can be an important consideration for organisations, particularly for those who believe that retention of a critical mass is essential for the long-term effectiveness of the organisation. (Sub. 199, p. 14)

The Local Government and Shires Association of NSW considered it desirable to develop the skills to conduct CTC within local governments:

Any widespread and indiscriminate long-term reliance upon external contracting resources will undermine implementation and deprive the organisation and the local community of essential skills. (Sub. 290, p. 13)

In this regard, it is not uncommon for private sector firms to recruit staff from the ranks of external service providers to supervise the purchase of the relevant types of services by the firm (for example, for a firm to recruit an information technology (IT) specialist to manage its purchase of IT services). Agencies might also, in such circumstances, look to contract out the management of an outsourcing contract to the private sector (as the NSW Roads and Traffic Authority — see box C8.3), or to another government agency.

Staging the CTC process

Where agencies do not have a great deal of confidence that the level of skills is sufficient to introduce CTC in the organisation, this may be overcome by staging the process, allowing expertise to be built up over time within the organisation.

As the Waggamba Shire Council (Qld) put it:

People with experience with contract administration don't just pop up, time is required for the experience to emerge. (Sub. 19, p. 8)

Staging the process may be achieved in a number of ways. For example, an agency may choose first to tender activities which are of low dollar value or risk (see box C8.3).

Another approach would be to introduce CTC into the agency, one service unit at a time.

Recommendation C8.1

Where agencies are inexperienced or lack the confidence necessary to effectively manage the CTC process, they should consider strategies such as making greater use of available training and information, drawing on the experience of individuals and organisations outside the agency through recruitment or skills transfer, or staging the CTC process.

C8.4 Managing staff transfers and excess staff

Most state governments have issued guidelines on how their agencies should handle the transfer of staff to contractors, and redeployment and redundancy. These guidelines emphasise the need for staff to be treated equitably and fairly, while ensuring that the functions of the agency continue to be performed effectively.

For example, the South Australian Government's *Human Resource Management Principles* contain guidelines on the staffing aspects of CTC (SA DPC 1995, pp. 46-48). They address the process by which the agency will select or retain staff, the process by which the contractor will determine how staff are allocated to new positions, the terms and conditions of employment (including eligibility for special transfer payments, accrued superannuation and leave entitlements), arrangements for staff who decide not to transfer, and short-term secondments to the contractor.

Box C8.3: NSW Roads and Traffic Authority (RTA) — road maintenance

In 1990, the RTA began assessing the options for road maintenance contracting. It decided to undertake a pilot contracting project for the road network to assess the feasibility of contracting and to gain experience. In doing so, it first tendered for the preparation of the actual contract. Twenty companies tendered and the contract was awarded in August 1990 to the Australian-based project management firm CMPS&F.

Eight companies then tendered for the maintenance services contract which covered all road maintenance excluding bridge structure and traffic signals, and it was subsequently awarded to Boral. The RTA also chose to contract out the management of the maintenance contract as it was crucial to the success of the pilot project. CMPS&F was awarded this contract without tendering because of its existing understanding of the project. The management contract specified inspections, contract scheduling and supervision, reporting, dealing with complaints and accidents, handling emergency response and quality systems management.

The RTA compared the performance of the maintenance services contractor with the internally team. There was no statistically significant change in road condition in any of the networks over the period of the pilot road maintenance project and no evidence of any difference between the quality of the work performed by Boral and that of the RTA work force. Over the first six months Boral was 16 per cent cheaper than the RTA. During the second six months, Boral's costs were six per cent above those of the RTA as the RTA work force reduced their costs.

The RTA increased the size of the maintenance and management contracts for the remaining 12 months and awarded these to the existing contractors. At the end of the two-year period, both the maintenance and management contracts were retendered. The maintenance services contract was awarded to Boral, which was the lowest of the six tenders received. Boral's tender was approximately 25 per cent lower than the price it had bid the first time around. The management contract was won by CMPS&F and Sinclair Knight.

This example illustrates how skills can be contracted in when they are not available in-house. It also highlights that contracting a portion of the total service can be an effective way to test the market, develop skills and effectively structure the contracts.

Source: Domberger and Hall, 1995

The NSW Government's policy statement on "Managing Excess Employees" (NSW Premier's Department 1993b) contains guidelines on redeployment and redundancy of staff affected by restructuring of public sector agencies.

In the Australian Public Service, the Public Service Commission (PSC) issued in December 1995 a draft document, *Outsourcing: Human Resource Management Principles, Guidelines and Good Practice* (PSC, Sub. 309). It sets out the “policies and principles to be followed when managing the human resource aspects of outsourcing and provide[s] guidance and best practice examples on how to apply these policies and principles” (PSC, Sub. 248, p. 3).

In the Commonwealth, States and Territories, many aspects of redundancy and redeployment — such as the circumstances under which an employee is entitled to a severance payment or transition payment, how much severance payment is payable in the event of voluntary or involuntary termination, how accrued superannuation can be taken, the period of notice required, and the need for prior consultation — are governed by legislation or addressed in workplace agreements. Also, a number of common law cases have dealt with entitlements of employees to severance payments (CCH Australia Ltd 1995).

For example, under the Australian Public Service (APS) *General Employment Conditions Award 1995*, APS staff who are surplus to departmental or agency requirements (as a result of contracting out or other organisational restructuring) are redeployed if a suitable position can be found elsewhere in the APS. If a suitable alternative position cannot be found, they may be offered a voluntary redundancy package. If they decline the offer, involuntary redundancy takes effect after a stipulated period.

Similar arrangements exist for state and territory public sector employees. However, the amount of severance payment varies across jurisdictions.

Several jurisdictions require agencies to make a transition payment to employees who transfer to contractors under a negotiated arrangement. For example, the Western Australian Government’s *Public Sector Management (Redeployment and Redundancy) Regulations 1994* require the employing agency to make a transition payment to its staff of between four and twelve weeks’ pay, or such amount as determined by the relevant Minister.

In most cases, departments and agencies are able to negotiate their own terms and conditions of transfer, redeployment and redundancy with their staff, but would be expected at least to meet the minimum requirements set out in legislation and government guidelines.

There have generally been two strategies used in handling staff affected by contracting, the clean break strategy and the negotiated transfer approach.

C8.4.1 The clean break approach

Under the clean break approach, the positions of the agency's staff employed in the function being subjected to CTC are abolished. These staff are placed elsewhere in the agency or subject to the relevant redeployment and redundancy arrangements. The agency does not negotiate or arrange employment or conditions of service for any affected staff with the contractor, although employees are free to seek employment with it.

There are several potential advantages in this approach:

- it is administratively simple;
- the agency does not have to get involved in time-consuming and costly negotiations with the contractor; and
- all affected employees are treated in the same manner and are not faced with the need to make a choice between accepting a redundancy package and accepting a position with the contractor.

But there are also several potential disadvantages:

- there may be a perception of double dipping¹ where some employees get a redundancy package applicable to all excess staff, and obtain jobs with the contractor almost immediately;
- unions and affected employees may oppose the clean break strategy, particularly where there are large numbers of affected employees looking for subsequent employment; and
- the cost of redundancy packages payable to employees under a clean break approach is often greater than any payments required to encourage staff to transfer to the contractor under a negotiated approach.

The Department of Defence (Sub. 81) has used the clean break strategy, preferring not to make any arrangements to transfer staff to the successful bidder.

C8.4.2 The negotiated transfer approach

The negotiated transfer approach involves the agency negotiating arrangements with their staff and potential bidders for the transfer of staff to the winning contractor, including the number to be transferred and their pay and conditions. This generally occurs prior to the activity being contracted out. Where staff

¹ 'Double dipping' in this context refers to the situation where employees accept a formal offer of employment with an external contractor (as a result of a negotiated agreement with the agency) after they have already obtained a voluntary redundancy payment from the agency which contracts out the service.

accept a position with the contractor, they are expected to resign from the public service. Staff may be entitled to a transfer package, calculated on the length of service, but usually significantly less generous than full redundancy benefits. The treatment of accrued leave, and entitlements to superannuation may be negotiated. Staff who do not transfer to the new supplier are usually covered by the relevant redeployment and redundancy awards that ordinarily apply to excess staff, and may or may not be precluded from subsequent employment with the contractor.

There are several potential advantages in this approach:

- it provides employees with an opportunity to stay employed and minimises the potential disruption caused by CTC;
- it assists contractors to take advantage of the availability of skilled employees who are familiar with the delivery of the service; and
- it reduces the number of redundancies and hence the cost to government, after allowing for any compensatory or incentive payments to staff who transfer to a contractor.

But there are also several potential disadvantages:

- negotiations with affected staff, unions and the contractor are likely to be time-consuming and administratively costly;
- protracted negotiations may result in industrial disputation and unrest;
- transferring employees may be undesirable due to differences in culture and work practices; and
- it can place restrictions on the contractor's ability to determine whom it should employ and under what terms and conditions.

A number of agencies have used the negotiated transfer approach in dealing with excess employees. For example, the DVA used it in the transfer and sale of its Repatriation General Hospitals (see box C8.4). Melbourne Water also negotiated arrangements for the transfer of its employees to the contractors.

When negotiating terms and conditions for transfer of staff to a contractor, agencies need to take into account legislative requirements. For example, the *Industrial Relations Act* 1988, anti-discrimination legislation, and other

legislation relating to the management of the public sector contain provisions which are relevant to staffing issues during outsourcing.²

Box C8.4: DVA staff transfer arrangements

The following staff transfer arrangements applied under the transfer of the DVA's Repatriation General Hospitals:

- staff who were offered and accepted a comparable job (one within two per cent of APS salary with similar duties and work patterns) were deemed to have resigned from the APS on the eve of transfer. Staff who did not accept a comparable job were deemed to have resigned;
- staff offered a non-comparable job could accept the job or opt for redeployment or voluntary retrenchment. Staff opting for retrenchment under this provision were precluded from employment with the State for a period of twelve months unless the pro-rata amount of severance entitlements was returned to the Commonwealth;
- safety nets for staff who may have been adversely affected by transfer existed within the agreements which provided a right of return for a set period;
- income maintenance provisions existed to ensure staff were compensated where State salaries were less whether the job offer was comparable or non-comparable; and
- there was access to certain APS conditions post transfer, including transfer of accrued recreation leave, sick leave and long service leave.

Source: DVA (Sub. 110, p. 13)

C8.4.3 Assessment of the clean break and negotiated transfer approaches

Most state governments have addressed the issue of which strategy should be used by agencies in the management of human resources in their guidelines for CTC.

² Member countries of the European Union have passed legislation to give effect to the EU's 1977 *Acquired Rights Directive* to require conditions of employment to be maintained during the transfer of a business undertaking. In the United Kingdom, the *Transfer of Undertakings (Protection of Employment) Regulation* 1981 originally excluded public sector contracting from its ambit, but amendments in 1993 led to its inclusion. Nonetheless, there continues to be legal debate on what constitutes a 'transfer of an undertaking'.

There are significant advantages and disadvantages involved in employing either of the strategies discussed above. The appropriate approach is likely to differ between agencies, and even from case to case. As the PSC put it:

... it is important to understand that different options may be appropriate in different circumstances depending on, among other things, the size of and nature of the function to be contracted out, the skills required to be transferred and the general state of the economy and the labour market. (Sub. 74, p. 7)

For example, the clean break approach may be more appropriate where:

- the likelihood that negotiating a suitable agreement with the successful bidder will be difficult, time-consuming or costly; and
- affected employees have not expressed an interest in transferring to the successful bidder.

The negotiated transfer approach may be more appropriate where:

- there are large numbers of affected employees eligible for redundancy payments;
- it is important to retain existing expertise and minimise disruption to a service; and
- the contractor has expressed an interest in employing some or all of the affected staff.

The Commission concludes that it is not possible to prescribe any one approach to managing excess staff that should be taken by individual agencies. There are likely to be circumstances which would render either the clean break or the negotiated transfer approach more appropriate.

C8.4.4 Implementation issues

Regardless of the approach agencies take in managing staff affected by CTC, some important implementation issues arise. While the clean break approach is, by its nature, less complex and protracted, this does not imply that agencies should take less care in managing human resources than they would in negotiating transfers to the contractor.

Where agencies have decided to follow the negotiation or phased approach, there are two major issues:

- whether contractors should be required to employ public sector staff displaced by the outsourcing, and required to pay existing wages, conditions and accrued entitlements; and

- whether transfer of staff to the contractor should negate any claims to redundancy payments (ie. double dipping) or re-entry into the public sector.

Transferring staff, wages and conditions

This section discusses the issues of whether, as part of the outsourcing contract, a private sector contractor delivering a government-funded service should be required to take on some or all of the existing staff, and to do so on public sector terms and conditions.

In a number of cases government agencies have encouraged or required successful bidders to guarantee employment for at least some of the workers displaced by outsourcing.

For example, in South Australia, the *Human Resource Management Principles* state that the Government is keen to support as many employees moving to the contractor as possible (SA DPC 1995, p. 46).

Similarly, while Victorian Government guidelines do not require contractors to take on existing staff, they state that the Government expects a contractor to “use its best endeavours to employ all or most” of the existing staff (Sub. 289, p. 3).

Contractors often see value in taking on at least some of the public sector staff who were previously employed in the activity. These employees are generally experienced and have in-house knowledge that often takes time for the contractor to build up. For example, the Local Government Association of Tasmania observed:

It is highly likely that the private sector would target valuable personnel in order to improve their capacity to undertake local government contracts. But it may be impractical to attempt to control the sector labour market. (Sub. 132, p. 12)

The Civil Contractors Federation considered that, in the civil construction and maintenance sector, encouragement should be given to contractors to take on government employees, since many have been found to adapt well to the private sector environment (Sub. 252, p. 8).

The Australian Manufacturing Workers’ Union argued that most successful contractors wish to maximise the number of former public sector employees who transfer to them (Sub. 299, p. 9).

Other participants opposed mandating a requirement on contractors to guarantee the employment of staff. For example, Skilled Engineering considered:

... the decision on rehiring of existing people into contracted out work sites should be a matter left to discussion, negotiation and agreement between the parties involved in the

proposal. Each contracting out activity is unique and no standard rules or clearly defined requirements are appropriate. (Sub. 69, p. 8)

And the Local Government and Shires Association of NSW commented:

Prescription that external tenderers assume liability for affected staff ... is an unrealistic expectation of a successful tenderer. In some instances, labour exchange may be at least partially appropriate, but as a mandatory requirement, would be contrary to the efficiencies and measurable effectiveness expected by a contractor. (Sub. 290, p. 13)

Best Practice argued that transferring displaced employees may be undesirable because they may not be amenable to a change of culture:

For a variety of reasons — often linked to corporate culture — many, maybe most, contractors will not want to employ the displaced public sector employee. Whilst the situation is not completely similar, it is generally believed that Optus will not employ ex-Telecom employees — because of the ‘baggage’ of Telecom attitudes and approaches they would bring to that particular dynamic customer driven organisation. Likewise the Managing Director of the Commonwealth Bank has recently been quoted on the problems of changing the public service culture of his new actively competitive and part-privatised company to match that of industry pace setters. (Sub. 26, p. 18)

Apart from the number of staff, a related question is the terms and conditions under which the agency’s staff are employed by the contractor.

Some agencies have sought to transfer their employees’ public sector terms and conditions to the contractor.³ For example, Ferrier Hodgson Corporate Advisory indicated that it was not uncommon in Victoria for bidders to be required to observe minimum standards of wages and conditions for transferring employees and to undertake to keep taking employees on those wages and conditions for a minimum period of time, for example, one or two years. It argued that it is inappropriate to require the private sector to employ public sector staff at their existing wages and conditions:

It would make no sense in my view for public service employment conditions to be literally transferred over to the private sector. ... ultimately employees who transfer have to be subject to normal market forces. (Transcript, p. 1577)

Boral Asphalt argued:

Wages and conditions that currently exist with agency employees should not automatically transfer to contractors. Contractors have award conditions or enterprise agreements that cover these activities and public agency conditions may be counter productive. (Sub. 120, p. 8)

³ The Australian Municipal, Administrative, Clerical and Services Union has lodged a claim with the Australian Industrial Relations Commission, which seeks to have all those working on Victorian local government contracts paid at local government award rates.

The Commission recognises that there may be benefits to the contractor, agency and staff in transferring staff to the contractor. However, it does not support contractors being required to take on any staff. To do so would restrict their capacity to determine the composition of their workforce, including the skill mix, in the way they consider best, and may impose significant costs where some of the employees are not suited to the organisation.

The Commission considers that arrangements for the transfer and employment of public sector staff, including terms and conditions of those who transfer, should be a matter for negotiation involving the successful bidder, the government agency and its staff and their representatives, and should not be mandated by government. Just as contractors should be free not to offer a position to any particular worker, each staff member should also be free not to accept a transfer to the contractor. In such cases, the staff member should retain his/her right to redeployment and redundancy.

In the Commission's view, these arrangements are consistent with fair and equitable treatment of affected staff and the contractor, and would also assist in promoting the continuing effectiveness with which government-funded services are provided.

Recommendation C8.2

Contractors should not be required to employ any given number of displaced public sector employees, nor should they be required to employ them on their existing public sector terms and conditions. The terms and conditions of any public sector employees who transfer should be settled through negotiations involving the contractor, the government agency and its staff and their representatives. Contractors should be free not to offer a transfer position to any particular member of staff. Employees should be free to reject a job offer and retain entitlements to redeployment and redundancy.

A few participants such as the Australian Council of Social Service (Sub. 310, p. 17) and the Australian Liquor, Hospitality and Miscellaneous Workers Union (Sub. 245, p. 3) suggested that public sector wages and conditions should be able to be transferred in order to achieve EEO objectives. The merits of transferring terms and conditions such as EEO to all staff (including both those transferred from the public sector and others) employed by a contractor to provide government-funded services, are discussed in chapter B5.

Entitlement to redundancy payments

Where there is a negotiated transfer, staff may have a choice between accepting a formal offer of employment by the contractor on negotiated terms and conditions, or rejecting the offer and being subject to redeployment and redundancy. 'Double dipping' would occur when employees accepted a negotiated transfer, and also received the voluntary redundancy benefits which are available to staff who do not accept a transfer.

The PSC argued:

Where staff are leaving the work force or leaving the APS with no guarantee of employment with the new supplier or no transfer of accrued credits if they accept employment with the new supplier then the payment of a severance benefit is appropriate. Staff who have the benefit of a job with the new supplier, facilitated by the Commonwealth on terms and conditions of employment negotiated by the Commonwealth, should not be able to also obtain a voluntary redundancy package. (Sub. 74, p. 5)

Double dipping does not arise when there is a clean break, because staff are not guaranteed a job. All staff are declared excess and managed in accordance with standard provisions for redeployment and redundancy, though they are not necessarily precluded from applying for work with the winning bidder after receiving a redundancy payment. However, depending on how the process is handled, there could still be a perception of double dipping if very few staff accept a negotiated offer of employment, and many end up eventually working for the contractor after receiving a redundancy payment.

In the case of the DVA's outsourcing of the National Computing Centre (NCC), 18 of the affected 33 staff elected to take a voluntary redundancy package. None chose to transfer to the contractor under the terms and conditions which had been negotiated by the Commonwealth. However, all but two of the 18 redundant employees subsequently took up employment with the contractor and did so without losing their redundancy benefits (Auditor-General 1992b).

The Auditor-General's report identified deficiencies in the framework for managing the process. Ministerial approval of the negotiated transfer was based on an expectation that there would not be significant numbers of NCC staff who would accept a voluntary redundancy package and subsequently obtain employment with the contractor. A major problem was that the contractor made job offers to staff too late in the process.

The situation was different with the DVA's transfer of Repatriation General Hospitals to the States. Those employees who were offered and accepted a comparable job were deemed to have resigned from the APS on the eve of the transfer and ineligible for redundancy benefits (see box C8.4).

Some governments have issued guidelines to reduce the extent of double dipping. For example, the PSC's draft guidelines on outsourcing recommends that applicants who accept a negotiated job with the new service provider be identified prior to the activity being outsourced, so that they do not receive both an offer of voluntary redundancy and a job with the new provider prior to the activity being outsourced (Sub. 309, pp. 1–6).

The Western Australian Treasury's draft policy principles on transition costs state that an employee receiving an incentive payment (to transfer to a contractor) is normally not eligible for a redundancy payment (WA Ministry of the Premier and Cabinet, Sub. 311, attachment B, p. 1).

The justification for restricting the ability of staff to accept redundancy benefits and obtain subsequent employment with the contractor appears to be to limit the ability of the individuals to improve their situation at the taxpayers' expense. As Ferrier Hodgson Corporate Advisory commented:

To me it's double-dipping for people to get their redundancy and then seek to be re-employed again. I don't think that's in the best interests of us as taxpayers. They are continuing their current nature of employment, however, they are no longer working for the government, they're working for a private sector employer. (Transcript, p. 1574)

However, the Department of Defence argued that such limitations may disadvantage the employee because:

... we would need to take into account the fact that the contractor might find them unsuitable for his or her method of operations and they may not last in the function and yet they have forfeited all their entitlements under the existing award provisions. (Transcript, p. 591)

Of note also is the decision in the NSW Government Cleaning Service case (see box C8.5).

Double dipping is undesirable on equity grounds because it allows some workers to receive a full payment of voluntary redundancy as well as a formal offer of employment with the contractor while others from the same work unit may be redeployed. This may increase the incentive for affected employees to position themselves to receive a redundancy payment. It also significantly increases the costs of CTC to tax and ratepayers.

A further argument against double dipping is that the payment of voluntary redundancy is in part meant to compensate excess staff for non-transferable skills accumulated during their period of employment. If these skills have an application with a new employer and are transferred along with the employee's position, it is inappropriate to pay full voluntary redundancy to that person.

Box C8.5: Redundancy payout to former employees of the NSW Government Cleaning Service

In July 1993, the NSW Government announced its decision to privatise the Government Cleaning Service and competitively tender the cleaning of NSW government schools. At the time of the sale, about 7500 cleaners were employed by the NSW Government. Policy guidelines issued by the NSW Government required that staff transferring to a contractor under the terms of a negotiated arrangement would not be entitled to an immediate redundancy payment. However, their eligibility for severance payments at the level of other NSW Government employees continued to apply during the life of the first contract (three to five years).

In September 1993, the Federated Miscellaneous Workers Union submitted an application for redundancy under the *Industrial Relations Act* 1991 arguing that employees had been made redundant by the State Government despite their transfer of employment. Justice Schmidt of the New South Wales Industrial Relations Commission agreed. In her decision, Justice Schmidt stated that two important characteristics of redundancy were present, namely that the decision to terminate had been made by the employer and that it was unrelated to the employee's work performance. She considered:

The case is one which poses great difficulty in ensuring that justice is achieved between the parties. Each party has advanced cogent arguments in support of its views. On balance, and I must say with some reservations, I have concluded that it is appropriate that an award of redundancy pay should be made in favour of the former GCS employees.

The unions had sought a redundancy payment of approximately two weeks pay for each year of service to a maximum of 26 weeks, based on the scale for voluntary redundancies fixed by the NSW Government. However, Justice Schmidt considered this "entirely inappropriate in the circumstances", and she awarded payments of nil for those who had worked less than one year to a maximum of 12.5 weeks for those aged over 45 years who had worked for 6 to 7 years. Allowance was made for the fact that staff were not facing the prospect of finding new employment (as in the case of those who receive voluntary redundancy), and accrued entitlements to leave and superannuation were maintained during the life of the first contract. The determination was estimated to result in a total redundancy payment of \$25 million.

The full bench of the Industrial Relations Commission upheld Justice Schmidt's ruling on appeal (May 1995).

Source: Hall and Domberger 1995 and LHMU (Sub. 245, Attachment)

Nonetheless, in some cases it may be appropriate to provide some form of compensation or incentive payment in recognition that staff transferring to the private sector may need to be compensated for loss of job security, reduced superannuation benefits or some other factors. For example, the benefit could take the form of an actual payment, the “freezing” of redundancy entitlements for a limited period⁴, or eligibility to return to the public sector. Transition costs may end up being less if some employees can be enticed to receive other benefits rather than the full amount of voluntary redundancy.

On the other hand, it would be unreasonable not to allow public sector employees the choice between accepting a negotiated transfer and being subject to the standard redeployment and redundancy arrangements that are available to other public sector employees.

Some employees may decide not to take up the offer of a negotiated transfer. Unless restrictions are imposed, they could apply for a position with the contractor even after they have accepted a severance payment for voluntary redundancy. In this situation, there is a risk that some staff will reject the initial offer of a negotiated transfer, in the hope of obtaining voluntary redundancy and subsequently being offered employment with the contractor. Whilst they would then no longer be subject to the negotiated terms and conditions, employees who successfully applied for a job with the contractor immediately after obtaining a full redundancy payment would be perceived as having ‘double dipped’. This would detract from the incentives which are offered to staff to transfer to the contractor.

The Commission concludes that staff who accept a voluntary redundancy package offered as part of a decision to contract out a government service should be precluded from working with the external contractor on the relevant outsourcing contract for a specified period.⁵

⁴ For example, the City of Port Phillip has proposed as part of its negotiations with workers, that those who transfer to a contractor remain eligible to claim the redundancy entitlements accumulated during their period of employment with the Council, during the twelve months following their transfer.

⁵ Western Australian Government guidelines require that an external contractor not employ displaced public sector staff to work on the relevant outsourcing contract for the period of time that they receive payments for redundancy, and payments in lieu of accrued leave (see WA PMSO 1995, Section 5, p. 1).

Recommendation C8.3

Where a contractor, the government agency and its staff and their representatives negotiate a transfer package (including, where appropriate, some form of compensation or incentive payment to employees) and an employee is offered and accepts the package, this should negate the employee's ability to claim the payments for voluntary redundancy available to public sector employees who do not transfer. Those who accept voluntary redundancy offered as a result of contracting out should be precluded from working with the contractor on the relevant outsourcing contract for a period of time.

C8.5 Conclusion

Any reform initiatives aimed at improving the efficiency and effectiveness of public sector agencies, such as competitive tendering and contracting, will involve significant changes to workplace practices and operations. Achieving the commitment of management, consulting with staff and their representatives, and developing approaches to dealing with affected employees are important to the success of any workplace reform.

Where the skills required for managing the CTC process are inadequate, this could be addressed in a number of ways including training of existing staff, recruiting in-house managers, engaging consultants, and short-term secondments.

There are two broad approaches for managing excess staff — 'clean break' and 'negotiated transfer'. Each approach is likely to be more appropriate for some circumstances than others, hence it is not possible to prescribe the approach which should be taken by individual agencies.

Arrangements for the transfer of public sector staff to the contractor, including the terms and conditions of those who transfer, should be settled through negotiations involving the agency, its staff and their representatives, and the contractor, and should not be mandated by government. Employees should be free to reject an offer of a negotiated transfer and retain their entitlements to redeployment and redundancy.

'Double dipping' is inequitable, increases the cost of CTC to tax and ratepayers and should be prevented. However, in some cases, it may be appropriate for governments to provide some form of compensation or incentive payment to staff who transfer to the contractor.

Employees who receive a voluntary redundancy package should be precluded from working for the contractor on the relevant outsourcing contract for a given period, in order to reduce perceptions of double dipping.

C9 THE WAY AHEAD

C9.1 Introduction

The reforms outlined in earlier chapters of this report offer a range of benefits for governments and the community. Competitive tendering and contracting (CTC) is examined as one aspect of a suite of public sector reforms facing Australian governments. As noted in chapter A1, the introduction of accrual accounting, budgetary reform and developments in commercialisation are all occurring in tandem with moves towards CTC.

The transition to CTC is a key consideration for this inquiry. It is likely that the use of CTC as a management tool will become more prominent over time. For many activities or agencies, the transition to a CTC environment is a substantial reform, involving a change in the culture of the organisation from an integrated service supplier to separate and distinct purchaser and provider roles. Human resource management issues, including staff transfer, reskilling and redundancy arrangements, together with the agency's understanding of the external market and contract management skills are aspects of this cultural change.

It is important to ensure that during the transition period potential problems are addressed and mistakes minimised. This will help ensure that the benefits provided by CTC, as discussed in chapter B3, outweigh any transitional costs, providing the community with a net benefit through the introduction (or expansion) of CTC.

This chapter examines implementation issues from two angles. First, it identifies the components of the transition to CTC and some of the characteristics that determine how governments and agencies should address transitional issues. Second, it examines those issues which are likely to become important as agencies make more extensive use of CTC. Included in this category are the changing roles of government and inter-governmental relationships, and those areas where governments are able to add further value to public sector reforms.

C9.2 Components of transition

The transition to CTC can be broken into three separate, though inter-related components. These are the pace of change, the order in which CTC is applied to various services, and the use of measures to facilitate the transition.

The *pace* of change encompasses how fast reforms should and can be implemented including the speed with which individual competitive tendering exercises are undertaken, and whether different services are contracted concurrently or one-at-a-time. The speed with which purchaser-provider distinctions and competitive neutrality arrangements are implemented, together with the time provided for an in-house team to get up to speed, are other important elements of the pace of reform.

The *order* in which CTC is applied to services is a second component of the transition to CTC (see box C9.1). Where agencies choose to implement CTC progressively, decisions need to be made on which services to contract first. This highlights the effects of parallel and complementary reforms, the potential for ‘learning by doing’ (particularly with regard to specification of service requirements and contract management) and the scope for harnessing the experience of other agencies.

Box C9.1: Phasing the introduction of CTC — the Port Phillip approach

The introduction of CTC at the City of Port Phillip (Vic) has been driven by a number of internal and external imperatives, including the desire to improve quality and accountability, and the need to satisfy requirements of Victorian compulsory competitive tendering legislation. To this end, the City of Port Phillip has developed a timetable for the staged introduction of CTC to the various services it presently provides or purchases.

The timetable staggers the introduction of CTC to various services, with calls for expressions of interest (and requests for tender responses) between May 1995 and May 1996. Support services, such as property management, payroll and records administration, were market tested between May and September 1995, with services such as aged and disability care and family and childrens’ services scheduled to be competitively tendered in mid-1996. The City emphasised that the timetable was intended as a guide only and that changes might occur.

*Source:*Sub. 170

The use of *facilitating measures* during the transitional phase may also be warranted to address potential transitional costs, smooth over possible problems or provide incentives to overcome institutional resistance. Some measures may be a necessary first step in getting the process started or act as a catalyst for further reform. In this category, mechanisms such as in-house bids, requirements for compulsory competitive tendering, compensation payments to affected workers (in addition to generally available labour market assistance) and retaining a ‘reserved’ market for in-house suppliers, may come into play.

Clearly, the components of transition are interrelated. The pace at which change can occur is influenced by the ordering of activities exposed to CTC, while both of those influence and are influenced by the facilitating measures undertaken.

C9.3 What influences the components of transition?

The components of transition are influenced by the external policy environment under which CTC reforms are progressing, as well as by agency level factors.

C9.3.1 The general policy environment

The general policy environment facing public sector agencies has been changing rapidly in recent years with a greater focus on objectives, the needs of clients, and performance information and evaluation. These policy changes will continue as the pressures for efficiency and effectiveness, which have given rise to them, continue.

In some cases, agencies may be required to take into account prevailing policies when structuring the pace and order of CTC implementation. Examples include compulsory competitive tendering in Victorian local government, and the remaining restrictions on activities able to be performed by private sector employees (see chapter C1).

Many reforms may be mutually reinforcing in that policy developments at a broader government level assist in the progress of CTC reforms at an agency level. For example, where governments have developed detailed *guidelines* pertaining to CTC or where an advisory unit is established to provide agencies with assistance on CTC issues, the scope to speed up reform is greater. The Commission has recommended that governments develop CTC-specific guidelines, where they have not already done so, as a matter of priority.

Some government-wide reforms, particularly those relating to *competitive neutrality*, will significantly affect the CTC environment and make the achievement of the benefits of CTC more likely. As part of broader reforms to Australia's competition policy regime, the Commonwealth, State and Territory Governments are to develop, by June 1996, policy statements on competitive neutrality, including the application of this concept to local governments (see chapter C5). These statements will be critical to engendering confidence in the CTC process amongst potential bidders and hence the level of competition that eventuates. In the interim, agencies may need to consider whether existing arrangements relating to competitive neutrality (including, for example, developments in the introduction of accrual accounting to public sector agencies) are adequate.

C9.3.2 Agency-level factors

In addition to the general policy influences external to agencies, a range of agency or service-specific characteristics should be taken into consideration when formulating the appropriate CTC transitional arrangements. These include the skills base available to the agency, the costs of organisational restructuring, the management culture and industrial relations environment, the extent and timing of savings generated and the nature of the relevant external market.

As discussed in chapter C8, the existing *skills base* available to the agency, or the agency's capacity to acquire or maintain access to the requisite skills, is a central determinant of the pace and order of CTC implementation. Without access to appropriate skills in the areas of service specification, tender development and evaluation, and contract management, it may be sensible for an agency to pursue CTC on a somewhat slower timetable. Limited access to skills also suggests that agencies should consider ordering the activities exposed to CTC, with priority given to those services where the scope for 'learning-by-doing' is relatively high (see box C9.2) or where there is scope to build on the approaches, documentation and experience of other agencies. Agencies should actively pursue such solutions to enable them to garner the benefits available from CTC as early as possible, rather than use 'lack of skills' as an excuse for delay.

Where the costs of *organisational restructuring* (including workforce restructuring through redundancy, staff transfers or reskilling) are substantial, agencies should factor this into the decision on the pace and order of CTC implementation. It may be possible to reduce the costs of organisational restructuring by temporarily slowing the pace of reform (eg allowing natural attrition instead of retrenchment), or phasing the implementation of CTC.

The costs of organisational restructuring may be partly a function of the existing *culture* or *industrial relations* environment within the agency. Where substantial changes to the organisation's culture (eg adopting new roles and responsibilities as part of the purchaser-provider distinction) or significant industrial relations issues are likely to arise, agencies should consider the implications of these on the pace and order in which CTC is implemented. Reducing the costs of transition may also be achieved by exposing initially those 'easier' services to CTC, that is, those requiring the least organisational restructuring or cultural change.

Box C9.2: Learning from experience — Victorian local government

In 1994, the *Victorian Local Government Act* was amended to require all councils to put to tender at least 20 per cent of total expenditure in 1994-95, increasing to 30 per cent by 1995-96 and 50 per cent by 1996-97.

Faced with this requirement, councils in Victoria have had to move quickly to prioritise services for contracting, develop specifications, negotiate tenders, and manage contracts. Previously, tendering processes had not been used as extensively in Victorian local government and councils faced the need to access a new range of skills in project and contract management. They have looked to a number of sources for assistance:

- experienced people have been recruited from the private sector;
- consultants have been used extensively to work with council staff;
- comprehensive CTC manuals have been developed by a number of councils, the Local Government Industry Working Party and others such as the Department of Defence's Commercial Support Program (CSP) manual;
- the Municipal Association of Victoria (MAV) has published a series of documents to assist councils identify the scope for tendering, manage compulsory competitive tendering, write tender specifications, establish business units and develop a costing framework;
- the MAV has established a comprehensive training program for councils;
- the Office of Local Government has developed a 'Code of Tendering' in consultation with council officers and contractors;
- a market has emerged for the exchange of contract and tender documents between local government agencies; and
- the Institute of Municipal Management has sought to establish a 'clearing house' for councils to buy and sell contract and tender documentation.

Lessons

- The introduction of CTC into Victorian local government has caused many councils to re-evaluate the adequacy of their skills in contracting.
- Councils are using a range of methods to address the skills shortage. The skills market is developing well.

Sources: Various submissions

The nature and *characteristics of external markets* should also be considered (see chapter C4). Where markets are inexperienced in meeting government requirements, there may be a role for slower implementation and staging of CTC to assist market development and ensure the agency realises the full potential of CTC.

Similarly, if the agency is unsure about the opportunities and pitfalls associated with external suppliers, it may be appropriate to stage the CTC implementation process and market test those activities for which the risk and cost of contract failure are relatively low. This approach helps to reduce the potential costs of contractor failure, while providing the agency with the opportunity to learn the characteristics of the outside market. Incorporating appropriate feedback and consultation mechanisms, improving the information flow between the agency and the external market (consumers and suppliers) would also be beneficial.

In all cases, the common theme should be the choice of a sensible pace and order to implement CTC, taking into account the relevant costs and benefits of alternative approaches. Importantly, where potential concerns suggest that a slower CTC implementation timetable may be useful, this should not be considered in isolation from the interests of a broader group of stakeholders. Those stakeholders are also looking at the likely *cost savings*, *quality improvements*, enhancements in *accountability* or other benefits (for the contracting agency or the wider community) generated by CTC.

C9.4 Mechanisms to facilitate transition

C9.4.1 The role for facilitating measures

Measures to facilitate the transition to CTC may include in-house bids, compulsory competitive tendering, compensation to affected groups and reservation of part of the market for internal provision. The pace and order of implementation may also be adjusted to facilitate CTC — for example, by slowing the speed of implementation or changing the order of CTC application to address transitional concerns.

However, agencies need to ensure that the application of facilitating measures does not compromise the progress of reform more generally. To this end, agencies should ensure that facilitating measures:

- are temporary in nature and do not lock the agency into specific measures for future CTC exercises;
- are implemented only where the benefits (in terms of smoothing the adjustment process) outweigh the associated costs; and
- are transparent, so there is scope to evaluate their usefulness.

Notwithstanding these principles, some measures which may have facilitating value may be retained on a more permanent basis. For example, in the case of in-house bids, the Commission is recommending that in-house bids be permitted

whenever the benefits they provide outweigh the associated costs (see chapter C5).

C9.4.2 Applying facilitating measures

Compulsory competitive tendering may be considered a form of facilitating measure to overcome institutional resistance. As noted in chapter C2, compulsion (as in Victorian local government) may be employed as a catalyst to reform where the culture of the organisation or other factors impede the implementation of CTC. In this sense, compulsion may be an appropriate solution to broad impediments which are difficult or costly to address directly. Once cultural impediments have been overcome, the role for mandated competitive tendering would be expected to decline.

Similarly, where the costs of organisational restructuring are likely to be substantial (reflecting the magnitude of the change), an agency may consider reserving a proportion of the market for internal provision as a stepping-stone to the introduction of full competition. The internal providers could then adapt to the competitive environment gradually, and the agency would realise, at least in part, the benefit of competition and the consequent ability to benchmark. This approach may also provide additional ‘security’ in terms of access to in-house capacity and knowledge, while the agency develops its understanding of the external market.

Compulsory in-house bids may also be considered as a transitional measure. By allowing staff the right to submit an in-house bid, without the requirement for all benefits and costs to be considered (implicitly assuming that the benefits in terms of smoothing the transition process outweigh any costs), agencies may overcome some industrial relations concerns surrounding CTC.

The Commonwealth Department of Defence has adopted a similar approach, with permission for in-house bids to proceed for all CSP tendered activities where civilian employees are involved. Similarly, the Commission understands that the Queensland Government intends to include in its forthcoming Competitive Service Delivery guidelines a provision allowing in-house teams the right to prepare a bid. Conversely, some states, including South Australia, Victoria and Western Australia, appear to discourage the use of in-house bids in agencies, whether employed as a facilitating measure or otherwise (see appendix B).

As noted in chapter C5, making in-house bids compulsory should, however, be balanced against the desirability of their being considered on a case-by-case basis, taking into account the particular benefits and costs involved in each situation.

C9.5 Beyond the inquiry

More widespread consideration of the contracting option by public sector agencies has the potential not only to transform individual agencies, but also to transform relations with their taxpayers and with other levels of government. In particular, it has the potential to provide greater client focus and responsiveness in service delivery. This change in the relationship between purchasers, providers and the clients will have important ramifications for accountability, management of service delivery, and other aspects discussed in this report. Some immediate issues that arise concern questions of policy responsiveness and the value added to the delivery of particular services by government involvement.

Agencies which formally separate the roles of purchaser and provider, so as to improve the overall efficiency and effectiveness of service delivery, will still need to be careful to keep policy development well informed by the experience of those directly involved in service delivery (and vice versa). Possible approaches include the use of performance information, consultative mechanisms, and policies for short-term interchange of staff. If such matters are not addressed and resolved, there is a risk that policy responses will be less effective.

As the skills needed within public agencies change to incorporate more skills relating to contract management, agencies will have to consider how to use those skills most effectively. For example, they may wish to establish a specialised CTC unit within their organisation.

Through clear and transparent specification of services and the monitoring of their delivery, and by demonstrating that a functioning market exists to provide the services, CTC makes explicit the relationship between the agencies and their clients. It provides governments with the opportunity to place much greater emphasis on service outcomes, as opposed to processes, and step back from the continued provision of 'standard' services to determine the most appropriate means of servicing an identified community objective.

This is not to suggest that governments have no role in service provision. Rather, they should continue to become more clearly focused on the fundamental objectives of their intermediation. This may include redistribution of income, standards setting, addressing market failure, community development or cohesion, protection of individual rights, public safety, use of purchasing power or some other objectives.

The same question of what value is being added will arise when more than one agency or level of government is involved in the chain between taxpayer and

client (see, for example, the discussion of health services issues in chapter C2). Where one level of government has funded services and others have provided them, or where there is shared funding (as with many Commonwealth, state and local government agreements), the contribution of each party as an intermediary between taxpayers and clients will come into greater focus when the service being provided has been transparently specified, costed and monitored. Questions which arise include:

- if the ‘providing’ agency makes the service delivery contestable, what role should the funding body play in the specification, selection and monitoring of the contractor?
- what continuing value does the ‘providing’ agency add?
- what tax level is the most appropriate to assess what services need to be provided?
- what level of government is best able to specify, select and monitor the provision of the services?
- how can activities be better coordinated across agencies or levels of government? and
- can clients or their representatives play a greater or different role in this coordination?

For jointly funded programs, or those where funding and provision are separated, these questions will be thrown into sharper focus by greater use of CTC. Indeed, some issues of ‘cost-shifting’ have already arisen in some areas (eg health — see chapter C2). This will put additional pressure on resolving funding issues between levels of government so the most cost-effective provider can be chosen and savings realised.

This inquiry has not attempted to answer these questions, but they will have to be addressed. They arise not just because of CTC considerations, but also as a result of the broader public sector reforms underway, and involve much broader considerations of intergovernmental relations and the role of government than this inquiry has been asked to consider.

COMPETITIVE TENDERING AND CONTRACTING BY PUBLIC SECTOR AGENCIES

Appendices

- A Inquiry participation and procedures**
- B Government policies on CTC**
- C Household refuse collection case study**
- D Survey of Commonwealth budget-funded agencies**
- E A review of empirical studies into the cost effects of contracting**
- F Cost case study — Amberley RAAF Base**
- G Quantifying the economy-wide impacts of CTC**

References

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APPENDIX A INQUIRY PARTICIPATION AND PROCEDURES

Following the receipt of the terms of reference on 8 December 1994, the Commission advertised the commencement of the inquiry in the press and invited submissions in an initial circular.

In January 1995, an issues paper and inquiry procedures booklet were distributed to individuals and organisations with an interest in competitive tendering and contracting (CTC). The issues paper defined the scope of the inquiry and raised issues of relevance to it.

During the course of the inquiry, the Commission held informal discussions with a wide range of individuals and organisations in each state and territory. Those visited included people at all levels of government, private companies, unions, community groups, not-for-profit organisations and academics. The organisations and individuals visited are listed in attachment A1.

Due to the timeframe for the inquiry, it was not possible to undertake formal overseas visits. However, the Commission has obtained information from various countries which has been drawn on in this report.

Initial public hearings were held in all capital cities except Darwin, beginning in Adelaide on 27 March 1995. In total 85 participants (individuals or organisations) appeared on the 18 scheduled hearing days — see attachment A2.

240 submissions were received by the publication of the draft report. Public hearings on the draft report were held in November and December 1995 in Adelaide, Sydney, Melbourne and Canberra. 19 participants attended on the 5 scheduled hearing days — see attachment A3.

A further 84 submissions were received prior to the completion of the final report. All submissions received during the inquiry are listed at attachment A4.

A workshop was held on 4 December 1995 to discuss certain aspects of the cost effects of CTC, as well as the assumptions and results of the Commission's modelling reported in the draft report. Practitioners and analysts with particular knowledge of CTC were invited. The 19 attendees, and the 10 who were invited but were unable to attend, are listed in attachment A5.

A consultancy was let to the CTC Research Team at the Graduate School of Business, University of Sydney to undertake a comprehensive survey of over 100 Commonwealth Government budget-funded agencies: the report is at appendix D.

Additional information and data were also requested from many organisations at various times during the inquiry. The Commission is grateful for the high degree of co-operation which it has received from participants.

Attachment A1 Visits

In the preparation of this report, the Commission had informal discussions with people from the following organisations:

New South Wales

Australian Consumer Association
Australian Liquor, Hospitality & Miscellaneous Workers Union
BHP Information Technology
Community and Public Sector Union
Corrective Services, Department of
Graduate School of Business, University of Sydney
Local Government and Shires Association
Miscellaneous Workers' Union
Mosman City Council
Newcastle City Council
Privacy Commission
Prospect Electricity
Public Sector Research Centre, University of New South Wales
Serco Australia
Singleton Shire Council
State Rail Authority
Strathfield Council
Sydney Water Board
Treasury, New South Wales Department of
Waverley Council

Victoria

Australia Post
Australian Earthmovers and Road Contractors Federation (now known as Civil Contractors Federation)
Australian Education Union
Australian Services Union
Ballarat, City of
Bendigo, City of Greater
Campaspe, Shire of
Coles-Myer
Consumer Advocacy and Financial Counselling
Employment Services Regulatory Authority (Commonwealth)
Ferntree Computer Corporation
Geelong, City of Greater
Health and Community Services, Department of

Hobsons Bay, City of
Institute of Municipal Management
Knox City Council
Melbourne, City of
Melbourne Water
Municipal Association of Victoria
National Australia Bank
Office of Local Government
Port Phillip, City of
Premier and Cabinet, Department of
Ramsay Health Care Group
Royal Melbourne Hospital
Silver Circle Home Support Services
St Kilda Community Centre
Spastic Society of Victoria Ltd.
Standards Australia Quality Assurance Services
Surf Coast Shire
Toyota Motor Corporation Australia Pty. Ltd.
Treasury and Finance, Department of
Victorian Council of Social Services
Wyndham City Council
Yarra City Council

Queensland

Administrative Services, Department of
Albert Shire Council
Brisbane City Council
Corrections Corporation of Australia
Emerald Shire Council
Emerald Chamber of Commerce
Harmer's Electricals Pty. Ltd.
JF Williams Pty. Ltd.
Health, Department of
Housing, Local Government and Planning, Department of
Queensland Chamber of Commerce and Industry
Queensland Corrective Services Commission
State Public Services Federation
Transport, Department of
Treasury (Queensland), Department of

South Australia

Building Management, Department of

Economic Development Authority
Engineering and Water Supply, Department of
Housing and Urban Development, Department of
Local Government Association of South Australia
Mayfield Electrical and Mechanical Engineers
Office of Information Technology
Premier and Cabinet, Department of
Public Service Association
Transport, Department of

Western Australia

Civil Service Association
Commonwealth Heads Network
 Administrative Services, Department of
 Australian Bureau of Statistics
 DASFLEET
 Defence, Department of
 Employment, Education and Training, Department of
 Finance, Department of
 Human Services and Health, Department of
 Native Title Tribunal
 Purchasing Australia
 Reserve Bank of Australia
 Social Security, Department of
 Trade Practices (now Australian Competition and Consumer) Commission
 Valuation Office
 Veterans' Affairs, Department of
Kalamunda, Shire of
Perth, City of
Premier and Cabinet, Department of
Swan, Shire of
Trades and Labor Council
Transport, Department of
Treasury, Department of
Water Authority of Western Australia
Western Australian Council of Social Service
Western Australian Chamber of Commerce and Industry

Tasmania

Community and Health Services, Department of
Hobart City Council
HydroElectric Commission

Industrial Relations, Vocational Education and Training, Department of
Launceston, City of
Premier and Cabinet, Department of
Primary Industry and Fisheries, Department of
Transport and Works, Department of
Treasury and Finance, Department of
Northern Territory (NT)

Association of Regional Directors of Commonwealth Departments (NT)
Administrative Services, Department of
Australian Electoral Commission
Office of Northern Development
Spectrum Management Authority
Auditor General's Department
Chief Minister, Department of the
Commissioner for Public Employment
Industries and Development, Department of
Litchfield Shire Council
Northern Territory Chamber of Commerce and Industry
Radiant Dry Cleaning and Laundry
JR Lighting and Electrical
Blackwoods Pty. Ltd.
Presentations Pty. Ltd.
Power and Water Authority
Transport and Works, Department of
Treasury, Northern Territory Department of

Australian Capital Territory (ACT)

Urban Services, Department of (ACT)
Administrative Services, Department of (Commonwealth)
Treasury, ACT Department of
Australian Federation of Consumer Organisations
Australian Local Government Association
Australian National Audit Office
Defence, Department of (Commonwealth)
Employment, Education and Training, Department of (Commonwealth)
Housing and Regional Development, Department of (Commonwealth)
Human Services & Health, Department of (Commonwealth)
Industrial Relations, Department of (Commonwealth)
Public Service Commission (Commonwealth)
Social Security, Department of (Commonwealth)
Veterans' Affairs, Department of (Commonwealth)

Attachment A2 Initial public hearings - participants*Adelaide — 27 & 28 March 1995*

Australian Earthmovers and Road Contractors Federation (now Civil Contractors Federation) — SA Branch
Byrnes, Mr Damian & Walsh, Mr Paul
Holistic Home Care
Law Society of South Australia
Local Government Association of South Australia
Public Service Association of South Australia
South Australian Council of Social Service Inc.
South Australian Employers' Chamber of Commerce and Industry Inc.
South Australian Government
Unley, City of

Perth — 30 & 31 March 1995

Australian Earthmovers and Road Contractors Federation (now Civil Contractors Federation) — WA Branch
Civil Service Association of WA
Meerilinga Young Childrens' Foundation Inc.
South West Groups
Spark and Cannon Pty. Ltd.
State School Teachers' Union of WA
Swan, Shire of
Trades and Labor Council of Western Australia
Volunteer Centre of WA

Brisbane — 5 & 6 April 1995

Australian Asphalt Pavement Association — Queensland Branch
Australian Earthmovers & Road Contractors Federation (now Civil Contractors Federation) — Queensland Branch
Electrical Contractors Association of Queensland
Local Government Association of Queensland
Queensland Corrective Services Commission
Sexton Textiles
Textile Rental and Laundry Association of Queensland

Canberra — 11, 12 & 13 April 1995

Alcohol and Other Drugs Council of Australia
Australian Agency for International Development
Australian Defence Force Academy

Australian Information Industry Association Ltd.
Australian Medical Association Ltd.
Australian National Audit Office
Commonwealth Ombudsman
Comsuper
Defence, Department of (Commonwealth)
Integrated Systems Solutions Corporation Australia Ltd.
National Library of Australia
Public Service Commission
Veterans' Affairs, Department of (Commonwealth)

Sydney — 18, 19, 20 & 21 April 1995

ALLCO Finance Group Ltd.
Association of Consulting Engineers
Australian Commercial Disputes Centre
Australian Earthmovers & Road Contractors Federation (now Civil Contractors Federation) — NSW Branch
Australian Law Reform Commission
Boral Asphalt
Combined Pensioners and Superannuants Association of New South Wales Inc.
Community Party of Australia
Couch and Associates
Evatt Research Centre
Grigg, Mr Durham
Independent Commission Against Corruption
Institute of Municipal Engineering Australia
Local Government and Shires Association of New South Wales
NSW Teachers' Federation
Office of the Privacy Commissioner
Public Sector Research Centre of the University of NSW
Serco Australia Pty. Ltd.
Sydney Water

Hobart — 27 April 1995

Australian Earthmovers & Road Contractors Federation (now Civil Contractors Federation) — Tasmanian Branch
Clarence City Council
Hobart City Council
Local Government Association of Tasmania
Tasmanian Government

Melbourne — 1, 2, 3 & 4 May 1995

Administrative Services, Department of (Commonwealth)
Association of Aerial Surveyors Australia Inc.
Association of Audiologists in Private Practice Inc.
Australian Association of Social Workers Ltd.
Australian Council of Trade Unions
Australian Earthmovers & Road Contractors Federation (now Civil Contractors Federation) — Victorian Branch
Australian Education Union
Currie and Brown, Cameron and Middleton
Electricity Supply Association of Australia Ltd.
EW Consulting Pty. Ltd.
Ferrier Hodgson Corporate Advisory
Human Services and Health, Department of
Institute of Hospital Engineering — Australia
Manningham City Council
Melbourne, City of
Municipal Association of Victoria
National Tertiary Education Industry Union
People's Justice Alliance
Port Phillip, City of
Skilled Engineering Ltd.
Victoria University of Technology
Victorian Council of Social Service

Attachment A3 Draft report public hearings - participants

Adelaide — 27 November 1995

South Australian Government
South Australian Council of Social Service Inc.

Sydney — 29 November 1995

Arthur Andersen
Association of Consulting Engineers
Bankstown City Council
Australian Superannuation Advisory Services Pty. Ltd.

Melbourne — 5 December 1995

Agency Contracting Services
Civil Contractors Federation
Employment Services Regulatory Authority
National Tertiary Education Union
People's Justice Alliance
Victorian University of Technology

Canberra — 12 & 13 December 1995

ACT Government
ACT Council of Social Service
Australian Council of Trade Unions
Australian Education Union
Defence, Department of
Public Service Commission (Commonwealth)
Serco Australia Pty. Ltd.

Attachment A4 Submissions received

<i>Participant</i>	<i>Submission</i>
ACT Council of Social Service, Inc.	79, 292
ACT Government	266, 308
Administrative Services, Department of (Commonwealth)	140, 209, 231, 300
Aged Care Australia Inc.	189
Agency Contracting Services Pty. Ltd.	281
Alcohol and Other Drugs Council of Australia	44
ALLCO Finance Group Ltd.	46, 177
Arthur Andersen	259
Association of Aerial Surveyors, Australia Inc.	101, 204
Association of Australian Aerospace Industries	137
Association of Consulting Engineers Australia	38, 222, 253
Association of Professional Engineers, Scientists & Managers, Australia	61, 297
Attorney-General's Department (Commonwealth)	175, 227, 291
AUSCRIPT	92
Australian Agency for International Development	47
Australian Archives	97
Australian Asphalt Pavement Association — Queensland Branch	94
Australian Association of Audiologists in Private Practice Inc.	50, 203
Australian Association of Social Workers Ltd.	23
Australian Broadcasting Corporation	42, 244
Australian Building Services Association	31
Australian Bureau of Statistics	111
Australian Chamber of Commerce and Industry	202
Australian City Transit Association Inc.	5
Australian Commercial Disputes Centre	9, 14
Australian Council of Building Design Professions Ltd.	130
Australian Council of Libraries and Information Services	265
Australian Council of Social Service	310
Australian Council of Trade Unions	75, 200, 293, 305
Australian Customs Service	187
Australian Earthmovers & Road Contractors Federation (see Civil Contractors Federation)	
Australian Education Union	33, 286
Australian Electoral Commission	91

Australian Electrical and Electronic Manufacturers' Association Ltd.	28
Australian Hearing Services	218
Australian Information Industry Association Ltd.	98, 287
Australian Law Reform Commission	64, 274
Australian Liquor, Hospitality & Miscellaneous Workers Union	27, 245
Australian Liquor Hospitality & Miscellaneous Workers Union —	283
Western Australian Branch	
Australian Manufacturing Workers' Union	299
Australian Medical Association Ltd.	63, 197, 235
Australian National Audit Office	107, 185, 307
Australian Superannuation Advisory Services Pty. Ltd.	255, 263
Australian Taxation Office	87
Bailey, Mr David	45
Ballarat, City of	257, 314
Balmer, Dr Colin	295
Bankstown City Council	247, 269
Best Practice	26
Blacktown City Council	160
Boral Asphalt	120
Brimbank City Council	41
Brisbane City Council	121, 219, 318
Brotherhood of St. Laurence	233, 312
Bureau of Meteorology	78
Burke, Council of the Shire of	181
Burnside, City of	136
Byrnes, Mr Damian & Walsh, Mr Paul	57
Cabonne Council	198
Calliope Shire Council	15
Civil Contractors Federation (previously known as the Australian Earthmovers & Road Contractors Federation)	
— National Office	53, 252, 306
— NSW Branch	125
— Queensland Branch	95, 115, 165
— South Australian Branch	48, 118
— Western Australian Branch	77
— Tasmanian Branch	176
— Victorian Branch	109, 188

Civil Service Association of WA Inc./Community and Public Sector Union SPSF Group (WA Branch)	65
Clarence City Council	37
Cleanaway Pty. Ltd.	206
Combined Pensioners and Superannuants Association of NSW Inc.	116
Commonwealth Funds Management	117
Commonwealth Grants Commission	105
Commonwealth Ombudsman	113, 243
Commonwealth Superannuation Administration	30
Community and Public Sector Union — National Office	313
Community and Public Sector Union — SA Branch/Public Service Association of SA Inc.	36, 271
Community Party of Australia	84
Couch & Associates Pty. Ltd.	122
CSIRO	24
Currie & Brown, Cameron & Middleton	146
Defence, Department of	81, 232, 285, 298, 323
Defence Housing Authority	112
Dwyer Building Services Pty. Ltd.	34
Education, Department of (WA)	284
Electrical Contractors' Association of Queensland	96, 182
Electricity Association of New South Wales	16
Electricity Supply Association of Australia Ltd.	145
Emerald Quarries	240
Emerald Shire Council	100
Emergency Management Australia	317
Employment, Education and Training, Department of (Commonwealth)	230
Employment Services Regulatory Authority (Commonwealth)	139, 278
Environment, Sport and Territories, Department of (Commonwealth)	102
Ethnic Communities' Council of NSW Inc.	90
Evatt Foundation	143
EW Consulting Pty. Ltd.	152
Family Support Services Association of NSW	55
FEPPi NT Aboriginal Education Consultative Group	21

Ferntree Computer Corporation	3
Ferrier Hodgson Corporate Advisory	167
Finance, Department of (Commonwealth)	267
Glen Innes Council	180
Glenorchy City Council	229
Great Lakes Council	183
Green, Ms Patricia	316
Grigg, Mr Durham	141
Guyra Shire Council	268
Hansen Corporation Pty. Ltd.	304
Health Insurance Commission	194
Hobart City Council	153, 275
Holistic Home Care	70
Housing, Department of (NSW)	256
Howle, Ms Pamela	12
Human Rights and Equal Opportunity Commission	147, 270
Human Services and Health, Department of (Commonwealth)	159, 226, 320
Independent Commission Against Corruption (NSW)	68, 250
Industry, Science and Technology, Department of (Commonwealth)	156
Inglewood, Council of the Shire of	10
Institute of Hospital Engineering, Australia	40, 166
Institute of Municipal Engineering, Australia	59
Institute of Municipal Engineering Australia — Queensland Division	184
Institute of Municipal Engineering Australia — NSW Division	282
Institute of Municipal Management	237
Insurance and Superannuation Commission	99, 301
Integrated Systems Solutions Corporation Australia Ltd.	88
Johnstone Shire Council	17
Kempsey Shire Council	178
Klauss, Mr Ian	1
Knox, City of	210, 321
Launceston City Council	29

Law Society of South Australia	149
Lehmann, Ms Jennifer	6
Lend Lease Employer Systems	133
Leung, Ms April	114, 238
Lithgow, Council of the City of Greater	168
Local Government and Shires Associations of NSW	54, 290
Local Government Association Mutual Liability Scheme	192
Local Government Association of Queensland Inc.	35
Local Government Association of South Australia	157, 195
Local Government Association of Tasmania	132
Local Government Association of the Northern Territory	213
Lucindale, District Council of	163
Maclean Shire Council	186
Manningham City Council	172
Marion, City of	212
Master Cleaners Guild of Western Australia Inc.	80, 241
Meerilinga Young Children's Foundation Inc.	173
Melbourne, City of	89, 319
Metropolitan Ambulance Service (Victoria)	224
Mudgee Shire Council	164
Municipal Association of Victoria	151, 302
National Anglican Caring Organisations Network	135, 220
National Bus Company	217
National Library of Australia	25
National Tertiary Education Industry Union	49, 279
National Transmission Agency	191
New England Local Government	211, 258
Nillumbik Shire Council	7
North Queensland Electricity Corporation	20
NSW Supply Service	221
NSW Teachers' Federation	131, 142, 254
Office of the Clerk of the House, House of Representatives (Commonwealth Parliament)	60
Outer Urban Research and Policy Unit — Victoria	56, 171, 276
University of Technology	
Pacific Waste Management	52
Parliamentary Reporting Staff, Commonwealth Department of the	67, 273

Penola, District Council of	127
People's Justice Alliance	154, 193, 280
Pitt, Mr Ross	62
Port Phillip, City of	73, 170, 261, 315
Post Office Agents Association Ltd.	39
Premier's Department, New South Wales	199, 294
Premier and Cabinet, Department of (Victoria)	289
Premier and Cabinet, Ministry of (WA)	106, 311
Printing and Allied Trades Employers' Federation of Australia	43
Privacy Commissioner	124, 179
Prospect, City of	13
Public Sector Research Centre	128, 214
Public Service Commission (Commonwealth)	74, 190, 248, 309
Public Transport Corporation (Victoria)	225
Public Transport Union	216, 234
Queensland Corrective Services Commission	148, 239, 324
Queensland Government	162
Queensland Historians Institute Inc.	169
Quiggin, Associate Professor John — James Cook University	22, 260
Redcliffe City Council	18
Repatriation Commission/Department of Veterans' Affairs (Commonwealth)	110, 196, 296
Resolution Centre	242
Resthaven Inc.	126
Richmond River Shire Council	174
Royal College of Pathologists of Australasia, The	134
Royal Institute of Public Administration Australia	251
Rural Industries Research & Development Corporation	83
Serco Australia Pty. Ltd.	144, 201, 303
Sexton Textiles	93
Shaw, Mr Keith	2, 11, 32
Shaw Pittman Potts & Trowbridge	246
Shoalhaven City Council	205
Silver Circle	223
Skilled Engineering Ltd.	69, 264
Small Business Development Corporation (WA)	103
Social Security, Department of (Commonwealth)	138

South Australian Council of Social Service Inc.	58
South Australian Employers' Chamber of Commerce and Industry Inc.	104
South Australian Government	123, 272
Spark and Cannon Pty. Ltd.	71
St Kilda Community Group Ltd.	208
State School Teachers' Union of WA Inc.	85, 129
Stonnington City Council	322
Surf Coast Shire	4
Swan, Shire of	158
Sydney Water	150
Tasmanian Government	108, 236, 288
Trades and Labor Council of Western Australia	72
Transport, Department of (Commonwealth)	82
Transport, Department of (Queensland)	207
Treasury, Department of (Queensland)	277
Tually, Mr Chris	86
Veterans' Affairs, Department of (Commonwealth)	296
Victorian Council of Social Service	155
Victorian Government	215
Volunteer Centre of Western Australia Inc.	66
Waggamba Shire Council	19, 262
Walcha Council	161, 249
Worksafe Australia	51
Wormald Security	76
Wyndham City Council	8
Wyong Shire Aged & Disabled Support Services Inc., Community Options Program	228
Yankalilla, District Council of	119

Attachment A5 Workshop on cost effects of competitive tendering and contracting out

A half-day workshop was held in Melbourne on 4 December 1995 to gain the views of participants on aspects of the draft report dealing with:

- the cost effects of CTC;
- inputs to the modelling exercise including the scope for CTC, efficiency/transfer assumptions and savings assumptions; and
- the outcomes of the economy-wide modelling.

The proceedings of the workshop were tape-recorded but have not been transcribed. Participants agreed that the discussion could be drawn upon for the final report.

The following individuals attended the workshop:

Mr D Cathers, Director, Engineering Services
Wyong Shire (New South Wales)

Dr C Chea, Principal Adviser, Economic Policy and Reform
Department of Premier and Cabinet (Victoria)

Ms E Chesterman, Director, Budget Sector Division
Treasury (New South Wales)

Mr R Collins, Senior Adviser
Local Government Association of Queensland

Professor S Domberger, Bowater Professor of Management
Ms. C Hall, Research Fellow
CTC Research Team, University of Sydney

Mr J Hickman, Chief Executive Officer
Port Phillip City Council (Victoria)

Mr T Lee, National Industrial and Research Officer
Australian Services Union

Mr M McNamara, Principal Adviser, Logistics Projects
Air Commodore D. Chipman, Director-General, Commercial Support Program
Department of Defence

Mr M O'Callaghan, Executive Director
Office of Public Sector Management (South Australia)

Dr M Paddon, Executive Director
Public Sector Research Centre, University of New South Wales

Professor B Parmenter, Deputy Director
Centre of Policy Studies, Monash University

Mr W Peel, General Manager, Corporate Policy and Government Relations
Department of Administrative Services, (Commonwealth)

Mr G Poropat, Business Analyst, Commercialised Services
Department of Administrative Services (Queensland)

Mr M Richardson, Principal Consultant
Premier's Department (New South Wales)

Mr I Stoney, Chief Executive Officer

Ms K Sykes, Economist
Municipal Association of Victoria

Mr R Sulikowski, Director, Commercialisation
Department of Treasury and Finance (Tasmania)

The following people were invited to the workshop but were unable to attend:

Mr S Bartos, Principal Adviser
Department of Finance (Commonwealth)

Dr P Botsman, Executive Director
Evatt Foundation

Ms W Campana, Assistant Secretary-General
Local Government Association of South Australia

Mr P Donald, Corporate Manager
City of Melbourne (Victoria)

Mr L Hannah, Director, Intergovernment Finance Branch
Treasury (Queensland)

Mr P Mussared, Deputy Secretary
Department of Treasury and Finance (Tasmania)

Associate Professor J Quiggin
James Cook University

Ms P Ranald, National Research Co-ordinator
Community and Public Sector Union

Mr R Watts
Health Services Union of Australia

APPENDIX B GOVERNMENT POLICIES ON CTC

B.1 Australian CTC policies

All Australian governments have general purchasing policies and guidelines. A number of them have also developed policies and guidelines specifically related to competitive tendering and contracting (CTC). There are also policies for particular purchases, such as for information technology (IT) services. Individual government agencies which undertake a large amount of competitive tendering have developed their own guidelines.

The development of CTC policies reflects the differing emphasis of each government on using CTC as a way of increasing the efficiency of service provision.

These policies need to be considered against other developments in public sector reform and competition policy. For example, the Competition Principles Agreement, endorsed by the Council of Australian Governments (COAG) in April 1995b (following from the Hilmer Report (Hilmer, et al 1993), contains several provisions about competitive tendering by government agencies.

While there are a range of policies affecting CTC, this appendix focuses on those which relate to key issues for this inquiry, including:

- CTC-specific policies and relevant guidelines;
- compulsory competitive tendering (CCT);
- in-house bids and competing in the private sector;
- prescribed tender processes;
- accountability;
- quality;
- industry development;
- access and equity; and
- human resource management and training.

B.1.1 Commonwealth Government

The Commonwealth Government does not have CTC-specific guidelines for use by all Commonwealth agencies. The main Commonwealth agency-wide

framework which affects CTC is the *Commonwealth Procurement Guidelines*. All Commonwealth agencies subject to the *Audit Act 1901* and *Finance Regulations* must have regard to this framework when purchasing goods and services. Other service-wide policies exist for the purchase of IT and consultancy services. Government trading enterprises are also expected to comply with these purchasing policies.

The key principles of the *Commonwealth Procurement Guidelines* (DAS, various years) are value for money, open and effective competition, ethics and fair dealing, maximising opportunities for Australian and New Zealand industry development and accountability. The procurement guidelines are being redrafted by the Department of Administrative Services (DAS).

CTC-specific procedures and manuals have been developed by individual agencies, such as the Departments of Defence and Employment, Education and Training and the Australian Agency for International Development, which tender a large proportion of their services.

Although the Commonwealth does not prescribe competitive tendering, some forms of CCT have been mandated by the Commonwealth Government:

- when Defence's Commercial Support Program (CSP) started in 1991, some 28 activities were specified by the Government for opening up to competition; and
- the *Australian Land Transport Development Act 1988* requires all new construction and most road maintenance work funded from Federal roads grants to the States and Territories to be subject to tender. Government agencies may bid.

Regarding the internal provision of services, *Finance Regulations* require agencies which operate through the Commonwealth Public Account to justify any internal provision of services that are also provided by the private sector or another Commonwealth agency. The final decision, based on a full cost comparison against potential suppliers, rests with the agency's chief executive officer. Guidance on costing internal activities is provided in the Department of Finance's 1991 costing guidelines.

Within Defence, in-house bids must be allowed where the jobs of civilian employees are involved, under the *Defence (Restructuring) Agreement 1994*.

To reduce the costs of the tender process, all Commonwealth agencies subject to the *Finance Regulations* must use certain centralised arrangements, including Common Use Arrangements (CUAs). CUAs remove the need for agencies to tender separately and are arranged by DAS (Sub. 140).

The Commonwealth's quality assurance (QA) policy requires agencies to specify fully certified QA for critical goods and services. An appropriate assurance of quality for less critical purchases may be obtained by other means.

Industry development is a key objective of the Commonwealth's purchasing policy and is met by:

- an Industry Impact Statement being prepared by the purchasing agency prior to the request for tender for purchases over \$10 million (and over \$30 million for government trading enterprises). The Statement identifies potential industry development opportunities which may be addressed by bidders. Industry development criteria may be included in the tender documentation;
- bidders submitting offers in two envelopes. One envelope specifies how the tender meets the tender specifications and the offer price, and the other contains the bidder's proposal addressing the industry development criteria;
- industry development undertakings which may be included as performance clauses in contracts; and
- agencies and the Department of Industry, Science and Technology monitoring contractor performance against industry development undertakings; but
- Defence is exempt from the policies listed above because it has structured procedures already in place regarding local industry development.

Policies which affect other non-price objectives of tendering include:

- the Commonwealth's Access and Equity policies which require agencies to incorporate these objectives in Commonwealth services delivered by the Commonwealth, other governments, community or private organisations. This often means that the objectives are incorporated into service contracts;
- Commonwealth agencies being required to purchase goods and services only from companies compliant with the *Affirmative Action (Equal Employment Opportunity for Women) Act 1986*;
- maximising employment opportunities for Aboriginal and Torres Strait Islanders where these arise through contracting (DAS Sub. 140); and
- the Commonwealth's *Better Buying Better World* policy which requires environmental impacts to be considered when purchasing goods and services (DAS 1992b).

In December 1995, the Public Service Commission (PSC) issued for comment a draft document, *Outsourcing — Human Resource Management Principles and Good practice* (Sub. 309, p. 1).

Training courses based on nationally endorsed procurement competency standards have been developed by Purchasing Australia and Defence to improve purchasing skills and assist staff. To date, courses in basic and intermediate purchasing have been developed. A university level course in advanced public sector procurement is still being developed to help staff with high risk, complex procurement (DAS Sub. 140). State and local governments have used these courses (Transcript, p. 1351).

B.1.2 State and Territory Governments

Most State and Territory Governments have developed CTC-specific policies or guidelines, but have different approaches to industry development, in-house bids and competition with the private sector. Several State and Territory Governments are committed to increasing the use of CTC to achieve greater efficiency and service improvements.

The Commonwealth and State governments have agreed not to discriminate in their purchasing of goods and services against companies on the basis of state of origin. Details of the Government Procurement Agreement are set out in box B.1.

Box B.1: Government Procurement Agreement

In October 1991, the Commonwealth, New Zealand and Australian State and Territory Governments agreed to eliminate interstate preferences in government purchasing and enable Australian and New Zealand suppliers to compete on an equal footing. They also agreed to apply zero preference margins to all purchases of services alone. It was agreed that specified margins would be applied to purchases of goods and related services from outside Australia and New Zealand. Queensland applies a margin of 20 per cent and Western Australia applies a margin of 10 per cent. New South Wales occasionally applies a margin of 20 per cent. Tasmania has not applied its rate (10 per cent) for several years. The Commonwealth, Victoria, South Australia, the Northern Territory, the Australian Capital Territory and New Zealand do not apply a preference margin.

Source: Purchasing Australia 1991

New South Wales

The NSW Government favours CTC where there are clear benefits to taxpayers. Decisions on the retention and contracting of tasks are based on selecting the option which contributes most to the efficient and effective achievement of the individual agency's mission (Sub. 199).

In his June 1995 *Financial Statement*, the NSW Treasurer indicated the Government's commitment 'to pursuing contracting and market testing'. Contracting is not compulsory, but agencies are motivated to obtain savings from contracting out as these can be retained for core priority services. In-house service providers are able to compete for contracts (NSW Government 1995). The Premier's Memorandum 95-36 to Ministers in September 1995 summarised this policy, indicating that all budget-sector agencies are to undertake market testing and contracting reviews as part of their formal business planning.

The NSW Government first published CTC guidelines in 1991 to provide assistance to agencies considering competitive tendering. The guidelines provide general assistance to agencies and can be adapted to their own particular needs.

Costing guidelines for CTC issued in 1992 detail how to cost an activity and specify the need to reflect the effects of taxation exemptions when comparing in-house with external bids. In 1993, the Government published *Contracting and Market Testing Policy* (NSW Premier's Department 1993a), which discussed issues such as how to decide whether to contract out a particular service and ensure probity and quality.

There is a range of other NSW Government policies which, although not specifically designed for CTC, affect services which may be subject to CTC. For example, the Premier's Department has published *Guidelines for the Management and Engagement* (1994) of *Consultants* and *Procurement and Disposal Guidelines* (1995b).

NSW Government agencies are not to market services which are supplied by the private sector, unless allowed by their charter, such as TAFE (NSW Premier's Department 1993a).

A guarantee of service statement should be developed by NSW Government agencies, regardless of whether the services are provided by the public service or contracted to the private sector. Contracting should only be pursued when it is practical to establish and monitor appropriate quality standards (NSW Premier's Department 1993a).

The NSW Government indicated that, with very large projects, it has made opportunities for Australian industry part of its selection criteria (Sub. 199).

Quality standards and access and equity requirements apply to both public and private sector service providers. Where appropriate, these requirements must be reflected in contract specifications (Sub. 199).

Private sector proposals that provide employment opportunities for existing public sector staff are to be given preference (NSW Government 1995).

Victoria

The Victorian Government is committed to contracting out to meet its objective of ensuring a more competitive and customer focussed service across all parts of Victoria. It has a preference for exposing Government funded activities to competition wherever possible (Sub. 215).

The Office of State Owned Enterprises (OSOE) first published CTC-specific guidelines in 1993. Revised in February 1994, they do not prescribe the tender process but outline the various stages and the issues to be considered at each stage (Victorian OSOE 1994). A more detailed and practical set of guidelines was completed by the Department of Treasury and Finance in December 1995 (Victorian Department of Treasury and Finance 1995).

The contracting out of public sector functions is not compulsory for Victorian Government agencies. However, it is government policy to encourage the competitive contracting out of functions wherever possible. In-house bids are rare and not encouraged but, when an operation is to be sold, there may be a management buyout. The Government should only directly provide those services for which markets do not exist or cannot be created (Sub. 215).

The Government recognises there may be cases where it is not cost-effective to contract out. This might occur where the costs of monitoring are greater than the benefits of contracting (Sub. 215).

The OSOE guidelines contain an example of how agencies should cost their bids to assess whether contracting should be undertaken (OSOE 1994). Tax equivalents have been introduced to achieve competitive neutrality between corporatised state bodies and private sector firms. Periodic market testing and regular contract review should be used to prevent capture by a contractor (Sub. 215).

While the principal objective of CTC is value for money, industry or regional development considerations may be addressed by using the two-envelope approach or mandatory requirements for tenderers to address these

considerations (Sub. 215). When contracting out IT functions, industry and regional development considerations should be considered in the assessment phase, consistent with Victorian policy on outsourcing IT services (OSOE 1994).

Key, non-price objectives such as 'Buy Australian', equal opportunity and Occupational Health and Safety (OHS) criteria, may be included in contract specifications (Sub. 215).

To ensure accountability, the contract should include a requirement to advise the contract manager on performance against key indicators and the nature and level of complaints received.

Quality accreditation is considered desirable when the consequences of service failure are significant (Sub. 215). Where appropriate quality accreditation regimes are available they should be employed.

For Government employees subject to the *Public Sector Management Act 1992*, s81A provides a process to place employees with a contractor or other body. This may involve the transfer of the employee's leave entitlements to the contractor or other body. While the Victorian Government does not require contractors to employ displaced employees, the Government expects that the contractor will use its best endeavours to employ all or most of the pre-existing agency's staff. If the employee rejects an offer comparable to his or her current position with the contractor and the employee cannot be transferred within the Department concerned, then the services of the employee may be terminated without compensation. Otherwise, normal public service redeployment procedures apply (Subs. 215 & 289).

Queensland

The main objective of the Queensland Government's use of CTC, or Competitive Service Delivery (CSD), is best possible value for money. The Government considers that not all government functions are suitable for CSD and does not believe that services are inherently provided more efficiently in the private sector (Sub. 162).

The Government has been developing a set of central guidelines on CTC. It has a detailed purchasing policy which applies to all service contracts.

The Government does not favour CCT and leaves the assessment of whether services are suitable for CSD to individual agencies. One of the fundamental principles likely to be included in the CSD guidelines is the recognition of an in-house unit's right to bid (Sub. 162).

As the Government considers that community well-being is best achieved by arrangements determined on the basis of value for money, the industry development objectives of the Government's purchasing policy are met by non-interventionist policies. These policies include overcoming lack of information and ensuring that the tendering process does not inadvertently discriminate against local industry. A preference margin of five per cent is applied to the Brisbane content of a tender when non-Queensland offers have been eliminated (Subs. 162 & 277).

Under the Government's procurement policy, government agencies are required to specify quality assurance systems based on internationally recognised quality system standards. However, where the risk of contract failure is lower, informal quality assurance systems are acceptable.

The Government's Information Policy Board has a policy on purchasing IT which aims to increase the benefits to agencies and develop the IT industry in Queensland.

Western Australia

The Western Australian Government encourages agencies to review all activities to assess their suitability for competitive tender. Agencies are to investigate activities where contracting has occurred elsewhere in WA and NSW, and subject these to CTC as soon as possible. Legislation is being drafted to remove barriers to CTC in the *State Trading Concerns Act*.

Agencies are not encouraged to invite in-house bids for non-core or support activities where strongly competitive markets exist. An in-house bid may be appropriate if it offers substantial savings and substantially increases competition. Agencies are encouraged to consider employee buyouts. Where there are bids from other government agencies, tertiary institutions and the private sector, bids from the private sector are preferred, unless government bidders possess unique expertise or are the only source of supply. Agencies are not allowed to use CTC to market their services to the private sector (WA Office of the Premier 1993 & 1994).

The WA Government developed competitive tendering guidelines for use by its agencies in 1994 to assist agencies evaluate these options. These guidelines draw on those produced by other states and the Department of Defence's CSP manual. They outline the process leading to the decision to tender and specify principles to be followed in implementing CTC (WA Public Sector Management Office (PSMO) 1994). A manual which provides more detail on the competitive tendering process was published in July 1995 by the PSMO.

The WA Treasury published costing guidelines in 1994 (revised in July 1995) to help agencies that are competitively tendering their services and to assist with the general reporting requirements of the Government.

Western Australia State Supply Commission also has a *Supply Policy Manual* (WA State Supply Commission 1995) which outlines the Government's purchasing policies as they relate to the environment and industry development. The supply manual and the recent CTC manual sets out training programs available to support managers implementing CTC.

Contract specifications are to include standards of service and quality to which the Government is committed, including recognition of the needs of special groups such as people of non-English speaking backgrounds, the availability of services to people with disabilities and to seniors, meeting required safety standards in the workplace, and conformity with equal opportunity laws (WA PSMO 1994).

When evaluating tenders, the treatment of public sector employees affected by contracting is to be considered. The criteria to be used will include continuity of employment guarantees and policies on equal opportunity (WA PSMO 1994).

The *Public Sector Management (Redeployment and Redundancy) Regulations Act 1994* specifies conditions for public sector employees affected by contracting out and privatisation. Employees accepting an offer of employment with the contractor are deemed to have resigned and receive a payment for loss of permanency. Employees made redundant by contracting receive the same entitlements as employees made redundant by other processes.

South Australia

The South Australian Government's primary objectives in pursuing CTC are to create greater efficiency and accountability in public sector operations while further developing the state's economy. There is no predetermined commitment to contract out any particular functions but the obligation is on agencies to develop and justify outsourcing initiatives to the Government (Sub. 108).

The Government has developed two sets of competitive tendering and contracting out guidelines. The 1995 guidelines for public sector managers detail the complete CTC process, including the Government's ten contracting out principles and seven stages of the tender process (South Australian Department of Premier and Cabinet (SA DPC) 1995). The private sector guidelines set out how they should structure their bids and contracting proposals to the Government. Costing guidelines are being developed (South Australian Economic Development Authority 1995).

Agencies are expected to consider in-house bids, but ensure that comparisons between in-house and external bidders are on an equal basis. In-house bids may only be excluded under special circumstances, for example, when there is an economic development proposal (SA DPC 1995). This has occurred when the Government sought tenders for the delivery of water and IT services.

The guidelines specify that:

- for high value contracts, an external ‘probity auditor’ should be appointed;
- service quality and standards must be specified and performance measured against clearly specified outcomes; and
- standards may include access for and needs of special groups such as senior citizens and non-English speaking people and compliance with OHS and equal opportunity legislation (SA DPC 1995).

Opportunities to attract industry to South Australia should be examined in the case of large contracts or where like contracts have been bundled together. To assess these industry development opportunities, a two-envelope system is used for the tendering process. One envelope is to address criteria such as the level of investment, direct jobs and the involvement of local industry. The second envelope will address the efficiency component of the contract. The assessment of the economic benefits will be carried out by a body independent of the contracting agency, in consultation with the SA Department of Manufacturing, Trade, Small Business and Regional Development. For contracts over \$1 million, the contracting agency will be required to prepare an Industry Impact Statement to detail the opportunities to the state (SA DPC 1995).

The development of the IT industry in South Australia was the objective of outsourcing the Government’s IT operations as outlined in the report of the Premier’s Taskforce on IT (South Australia 1994).

The guidelines outline the principles for the transfer of staff to contractors, including conditions of those who refuse employment offers and those who do not receive an offer (SA DPC 1995).

Tasmania

Although the Tasmanian Government does not yet have a formal policy on contracting, it has as a fundamental tenet that, where services are provided more efficiently by the private sector, government should withdraw from direct provision (Sub. 108).

To date, implementation of contracting has been unstructured and mainly left to individual agencies. To assist them implement contracting, the Department of

Treasury and Finance is currently developing policy and implementation guidelines for contracting out in consultation with all agencies. Agency specific guidelines have been developed by the departments of Community and Health Services, and Transport for their own use (Sub. 108, appendices B & C).

General tendering guidelines have been issued by the Department of Treasury and Finance. These are mandatory for departments but not applicable to government trading enterprises.

In-house bids are costed on an equal basis with external tenders. However, the Government does not encourage in-house bids. Costing guidelines will be issued as part of the implementation guidelines (Sub. 108).

The Government recognises that service delivery by community-based organisations can enhance access and equity because of their focus and commitment to particular client groups. Quality provisions in agreements specifically address access and equity issues (Sub. 108).

The Government also recognises that contracting out can be used as a component of economic development. The small size of the Tasmanian market tends to limit the number of service providers tendering for contracts and may limit the benefits of contracting. Where competition is limited, the Government has encouraged local firms to develop additional expertise to become contractors. Local economic development has been a component of some contracts, with the Government offering tenders in small bundles to make them more attractive to local firms (Sub. 108).

Staff transfers to contractors, redeployment, retraining and multi-skilling have been preferred to redundancies in some agencies. The Government prefers a flexible approach with staff arrangements being determined according to the circumstances of each case (Sub. 108).

Northern Territory

The Northern Territory Government has no CTC-specific guidelines but has a procurement policy which is committed to the maximum use of the private sector in the provision of public services. The objectives of the procurement policy include open and effective competition, value for money, enhancing the capabilities of local business and industry, environmental protection and ethical behaviour. The Territory's procurement policy is provided to the Minister by a private sector-dominated Procurement Advisory Council (NT 1994).

The procurement policy embodies a set of principles for all suppliers to the Government. The policy does not allow state or Commonwealth government

agencies to tender or compete against the private sector on Territory-funded projects without the prior approval of Cabinet (NT 1994).

To ensure quality, an accreditation scheme is used for civil, construction and service industries. Standard criteria against which contractors are assessed are determined by the relevant industry. A code of practice which details the standards the Territory Government expects from its contractors is set out in the procurement strategy (NT 1994).

The procurement guidelines outline how the Government's industry development objectives are to be achieved. For example, agencies are to give preference to local suppliers when other criteria such as price are comparable, and to give weighting to the advantages of buying local. Potential or known environmental impacts and lifecycle costing for all purchases are taken into account when assessing tenders (NT 1994).

Government policies with regard to the needs of particular groups are accommodated by the procurement policy, including the provision of support to developing Aboriginal communities.

Australian Capital Territory

The ACT Government is currently preparing guidelines for CTC. On compulsory competitive tendering, the Government's initial view is that it is unlikely that it will need to be adopted at this stage (Subs. 266 & 308).

The ACT Government's purchasing policy contains commitments to obtaining best value for money, ethical behaviour, open and effective competition and maximising opportunities for local suppliers. Use of ACT Common Use Contracts is mandatory. Commonwealth and NSW Government period contracts, which benefit the local region, are to be used where applicable (ACT 1994).

The Government's QA policy is to specify QA requirements when value for money would be improved and to favour companies with more highly developed quality systems when QA is a specified requirement.

Government purchasing also aims to maximise opportunities for local suppliers. This is achieved mainly by requiring agencies to ensure that local suppliers are made aware of requests for goods and services (ACT 1994).

The ACT Government has purchasing-related policies for paper recycling and equal employment opportunity (ACT 1994).

B.1.3 Local government

Local governments come under the jurisdiction of State and Territory Governments. Many state governments are reviewing their respective local government acts and are considering incorporating CTC policies into them. The most notable form of CCT in Australia has been applied to local government in Victoria by the Victorian Government.

However, competitive tendering has been a feature of local government activities for many years throughout Australia and several individual councils have developed their own tendering procedures.

New South Wales

The *Local Government Act 1993* and the *Tendering Regulation* prescribe the procedures and requirements for local government tendering. Councils must invite tenders before entering into most contracts over \$100 000. Open and selective tendering is allowed following public advertisement. Selective tendering is allowed after public calls for expressions of interest.

Exemptions from the provisions are limited. For example, the Act does not require councils in remote areas to invite tenders if, due to the council's remote location or lack of competitive tenders, a satisfactory result would not be achieved by tendering.

To foster greater accountability, the Act also requires councils to provide details in their annual reports of all contracts over \$100 000, other than employment contracts, whether they result from tender or not.

Victoria

The Victorian Government introduced CCT by amending its local government act. The *Local Government (Competitive Tendering) Act 1994* required that in 1994-95, services accounting for at least 20 per cent of a council's total expenses were to be competitively tendered. The minimum requirement rises to 30 and 50 per cent by 1995-96 and 1996-97 respectively.

In July 1994, the responsible Minister endorsed a CCT Procedures Manual prepared by an industry working party. In August 1995, the Minister launched a Code of Tendering which will be followed whenever a council tenders goods, services or works. The Code was developed by a working party comprising industry, private sector and government representatives and gives guidance particularly for in-house bids. The Code takes precedence over the Manual which is now being reviewed.

The Victorian Government submission identified barriers which prevent local government from tendering certain services. For example, some non-local government acts prevent councils from delegating certain functions and powers to non-council staff. The Office of Local Government is reviewing these provisions which mainly deal with the regulatory and enforcement functions exercised by councils. The Government considers that because of legislative and other practical constraints, some services (eg disability services in the health area) are likely to continue to be delivered by councils (Sub. 215).

The Act also requires councils to prepare a competitive tendering statement each year and have its auditor (from 1 July 1995, the Auditor-General) prepare a report on the statement. The statement must then be submitted to the Minister, who draws on the information from all councils to prepare his annual CCT statement to Parliament. Details of a council's contracts are recorded in its competitive tendering register. The register is open to public inspection and must also record the names of people who prepared each in-house bid (Sub. 215).

Queensland

Local government has a *Model Purchasing Manual*, for Queensland local government produced by the State Government. The manual sets out each stage of the tender process (Queensland Department of Housing, Local Government and Planning 1994).

The Local Government Act 1993 provides that, in entering into contracts for work, or the supply of goods or services, a local government must have regard to the principles of open and effective competition, value for money, enhancement of the capability of local business and industry, environmental protection, ethical behaviour and fair dealing.

The Act states that tenders must be called for contracts greater than \$100 000 in value and must be advertised in a local newspaper. An exception applies when council is satisfied that only one supplier is available or the contract is entered into with another council or a Queensland Government agency.

Where State Government loan funds or grants are used in local government projects, the Queensland Government Purchasing Policy is to be observed.

Western Australia

The *Local Government Act 1960* sets out the conditions under which councils may enter into contracts. The Act prescribes councils to invite tenders before entering into any contract by advertising in a local newspaper. A council may

also contract with other councils or government departments. The State Government is reviewing the Act.

South Australia

The *Local Government Act 1934* is being reviewed. Under the Act, councils are subject to audit, but there are no tendering requirements. The functions of a council include responsibility for continued improvement in the efficiency and effectiveness of council activities.

Tasmania

The *Local Government Act 1993* states that a council must invite tenders for any contract it intends to enter into for the purchase of goods or services valued at \$50 000 or more. The Act also states that a council may only accept a tender if, in all the circumstances, it is advantageous for it to do so. These conditions do not apply in an emergency.

Northern Territory

The *Local Government Act 1993* states that a council may enter into contracts for the purpose of carrying out its functions. Tendering procedures are not prescribed and vary between councils.

B.2 CTC policies in other countries

CTC is not just an Australian phenomenon. A growing number of countries are using CTC for the delivery of services: some have been doing so for more than two decades. The Commission found many case studies and examples where CTC has been used and this information has been drawn upon throughout this report.

The Commission also sought information on government policy on CTC from a wide range of countries. From the information gathered it is not possible to provide a comprehensive description of CTC policies although there is evidence of much activity:

- in Canada, there is a Parliamentary Committee review under way into the Federal Government's service contracting policy;
- in the United States, the National Performance Review report in September 1993 — *Creating a Government that Works Better and Costs Less* — raised CTC as one of a number of reform measures (Gore 1993); and

- the OECD is attempting to collect information on the extent of contracting out for a pilot set of 12 OECD countries, including Australia, France, New Zealand, Sweden and the United Kingdom.

Part of the difficulty in collecting comprehensive policy information reflects the fact that CTC is one of a range of market-type instruments that countries have been using in public sector reform and that much of the activity appears to be happening at the agency level rather than being co-ordinated by central policy-makers.

Some more detailed information is available, however, on government policies in New Zealand and the United Kingdom where policy appears to be more centrally driven.

B.2.1 New Zealand

National

The introduction of CTC by the New Zealand Government was part of a larger government program of public sector reform which commenced in 1984. At the central government level, the decision to competitively tender services is for individual agencies to determine. There are no centralised processes or instructions on when and how services should be competitively tendered. Agencies have autonomy over how they deliver services as long as they meet the underlying principles of the public sector reform program of efficiency, effectiveness, accountability and transparency.

Local Government

In 1989 the New Zealand Government introduced competitive tendering, amongst other reforms, to local government authorities through the *Local Government Amendment Act (number 2) 1989* and the *Transit New Zealand Act 1989*.

The former Act enabled local authorities to provide their services through companies, partnerships, trusts, incorporated societies or other means. Local authorities were given the power to establish Local Authority Trading Enterprises to provide services on a commercial footing. They were encouraged to consider the advantages and disadvantages of alternative methods of service provision, including internal provision, establishing Local Authority Trading Enterprises and contracting to the private sector (Brimble 1994).

The *Transit New Zealand Act 1989* required local authorities receiving Transit New Zealand subsidies for road works to apply competitive pricing procedure

for this work. Providers were also required to be either a separately constituted internal business unit, a Local Authority Trading Enterprise or a private contractor (Local Government Business Group 1993).

B.2.2 United Kingdom

The UK Government introduced CCT for some services of local government in 1980 and for the National Health Service (NHS) in 1983.

National

The UK Government introduced the *Competing for Quality* program in 1991. This entailed all central departments and government agencies reviewing their activities to determine if they needed to provide those services and, if so, whether there were more cost-effective means of delivery. Agencies were provided with a series of options, ranging from abolition of the service to internal restructuring, market testing, contracting out and privatisation. When the Government took a strategic decision not to continue as a direct provider of a service, in-house bids were not permitted. In all other cases, agencies were permitted to mount an in-house bid (Citizen's Charter 1991).

The Public Competition and Purchasing Unit was established within the UK Treasury to disseminate information on the practice of competitive tendering, market testing and contracting out. Its role is to encourage departmental sharing of experience and data on performance (Forshaw 1991).

The UK Treasury has initiated a review of the *Competing for Quality* program, with a report due later this year.

National Health Service

As part of its reform of the NHS, the UK Government introduced in September 1983 mandatory market testing for cleaning, laundry and catering services. This was extended under the *Competing for Quality* program to include regular market testing of management services, non-emergency transport, NHS supplies services and other support services (Citizen's Charter 1991).

Local Government

As part of a major reform to cut public expenditure, the UK Government introduced CCT for a few local government services under the *Local Government Planning and Land Act* 1980.

Initially, local authorities were required to adopt competitive tendering only for a proportion of construction and maintenance work on buildings and highways. Local authorities were only allowed to bid for contracts in these areas of work if they established separate trading units — Direct Labour Organisations, later renamed Direct Service Organisations — with their sole function being to deliver the services they won in a competitive bid. These units were not permitted to administer and manage contracts awarded after competitive tender (Friend 1992).

The scope of the Act was extended in 1988 to include garbage collection, street cleaning, internal cleaning of buildings, vehicle maintenance, grounds maintenance, school catering, other catering and the management of sport and leisure facilities.

The 1988 changes to the Act also addressed anti-competitive behaviour, providing that local authorities were not to 'restrict, distort, or prevent competition' when preparing contract specifications or awarding a contract. The legislation also sets out the broad procedures which must be followed in awarding contracts, such as advertising of tenders and results (Department of Environment 1993).

Under *Competing for Quality*, CCT was to be phased in for services such as finance, legal services, personnel and architecture, housing management, on-street parking, vehicle fleet management and security. The staged introduction was to enable local authorities to prepare for the changes in organisational structure and culture. For example, the first contracts for housing management are planned to be in operation from April 1996, whilst parking and vehicle management contracts for metropolitan and London borough councils have been operative since April 1995 (Department of Environment 1993).

APPENDIX C HOUSEHOLD REFUSE COLLECTION CASE STUDY

C.1 Introduction

In Australia the collection of household refuse is the responsibility of local councils. It is a highly visible service, with important implications for public health. As its cost and service output are relatively easy to measure (compared with education services, for example) and it is provided by both the public and private sectors, refuse collection provides a useful case study on the effects of competitive tendering and contracting (CTC). Many such studies have been completed in Australia and overseas. These case studies and the evidence in inquiry submissions and hearings provide information which enables a detailed review of the experience and lessons learned. Issues examined in this appendix include the reasons for contracting and its impact on cost, quality, employment, and accountability.

C.2 Contracting of refuse collection

C.2.1 Nature of the industry

The collection of household refuse is one of several waste management services provided by councils in Australia. Other services include the collection of recyclables, paper and cardboard, hard rubbish and sometimes green organics. While changes made to any of these waste management services may affect the others, the focus of this appendix is on the household refuse collection industry alone.

Refuse collection is a capital intensive industry, involving the use of large costly vehicles. Recent technological advances have brought major changes to the industry. These have included a move in many municipalities from the use of several 'runners' manually filling trucks to one-person vehicles with mechanical arms which pick up and empty bins, and the widespread adoption of larger 'wheelie' bins. These changes have reduced the previously high level of workers' compensation claims.

The industry has also been affected by government waste management policies. While the 1980s typically saw the introduction of the 240 litre 'big bin', the

1990s is seeing the use of smaller bins, typically 120 litres, in an effort to reduce waste generation. 'Split bins' have also recently been introduced by many councils to facilitate the collection of recyclables.

Contractors in the refuse collection industry vary in size from multi-nationals to small family-owned companies.

International waste management companies involved in the Australian industry include Cleanaway, Pacific Waste Management and Browning Ferris Industries. Cleanaway (a subsidiary of Brambles) has the largest share of the Australian market, collecting around half a million bins a week under more than 100 contracts with local councils in 1991. In the early 1990s it employed 2000 people across Australia. In 1993 Cleanaway won the tender for the City of Brisbane's garbage collection, one of the largest refuse collection contracts in the world. Pacific Waste Management (a subsidiary of Waste Management) is the second largest operator in the Australian industry, with operations in all Australian states. The company submits tenders on most new and renewing contracts (Kohler 1991, Sub. 52 and Sub. 219).

There are several medium-sized firms operating in Australia, including JJ Richards, Thiess, and Otto. Small contractors also play a significant role in some regions. When surveyed in 1988, many rural councils in New South Wales and Victoria used contractors who owned only one or two trucks, and held contracts with one or two councils (Rimmer 1993).

Overseas evidence suggests that there has been a trend over the years towards the rationalisation of the waste management industry, with a number of larger companies increasing their market shares. For example, in the 1970s four multi-million dollar waste management companies took over hundreds of small firms across the US and Canada (Crooks 1983). In France, by the early 1990s, the industry was dominated by the subsidiaries of the three largest groups (Digings 1991). It is not clear if this type of rationalisation has been replicated in Australia.

Limited evidence is available on the competitiveness of the refuse collection market in Australia. Data collected by the Evatt Research Centre in 1988-89 as part of a nationwide survey suggested that lack of competition was not a common problem then: only 10 councils cited the unavailability of contractors

as a problem in contracting out sanitation services including refuse collection, with five mentioning the shortage of tenders being received.¹

The market for refuse collection generally appears highly competitive in Melbourne and Sydney, with numerous contractors involved in the industry. While the precise number of industry contractors is not known, the 1995 Yellow Pages listed almost 250 rubbish removal companies in Sydney, and 220 in Melbourne.² In both cases, this is around double the number listed in 1992. In Sydney, 300 licences are currently held for the transportation of domestic garbage (New South Wales Environment Protection Authority 1995).

While little data is available on industry concentration, in Melbourne it is fairly low. At least twelve different companies provided refuse collection services to councils in the Melbourne metropolitan region in 1992-93. No one company held more than four of the 23 contracts let (Northern Regional Waste Management Group 1995).³ Interestingly, there is significant variation in the costs of refuse collection between Melbourne municipalities, ranging from around \$0.70 to over \$1.25 per household per week for like services (Hawke 1995).

Some refuse collection markets may be less competitive. The Shire of Swan expressed concern about what it claims is a lack of competition in Perth:

... there's a bit of a monopoly in waste management in Perth at the moment. There's only really one company who is into waste management and that's Cleanaway. They don't really have any competitors outside the local authority day labour workforce. (Transcript, p. 335)

C.2.2 Extent of CTC in the industry

Australia

The collection of household refuse is one of the most commonly contracted public services in Australia.

¹ While the Evatt Research Centre's definition of sanitation services included the collection of other refuse, recycling, sewerage and public convenience cleaning, household refuse collection accounts for about 40 per cent of the contracts grouped under this category. Further breakdown of results were not presented in this study (Evatt Research Centre 1990).

² Note that the 'rubbish removal' category used includes the collection of recyclables and industrial waste, and an array of non-kerbside collection methods such as mini-skips and walk-in bins. Thus, these figures overstate the number of companies capable of operating a scheduled household refuse collection service.

³ It appears that such data is not centrally collected for other cities.

A 1988-89 survey estimated that 55 per cent of councils in Australia contracted out refuse collection. The proportion of councils using contracting varied somewhat by state, from 67 per cent in Tasmania to 44 per cent in Western Australia. Sixty-one per cent of councils used contracting in New South Wales and Victoria.⁴

Contracting of refuse collection appears to have increased in recent years, with 71 per cent of the 151 respondents to a 1995 survey using contractors to collect at least some refuse, and 42 per cent using contractors to collect all refuse. While contractors were used extensively by councils in all sizes of jurisdictions, the use of contractors was most prevalent in large council areas (Waste Management and Environment Magazine 1995).

Many councils have been contracting out refuse collection for many years. Half of the New South Wales councils using contracting in 1988-89 had done so for over 25 years, with the use of contracting growing steadily over this period (Rimmer 1993). The Victorian municipality of Knox has been contracting out refuse collection for 30 years (Sub. 210). Brisbane City Council first tendered the service prior to World War Two (Sub. 219).

Overseas

While limited data is available, it appears that contracting out is used extensively in North America and Europe for refuse collection services. The service has also been contracted out in many other countries including Japan and Malaysia.

In the USA, over 50 per cent of cities of varying sizes contracted all or part of their refuse collection services in 1994 (Reason Foundation 1994b). In 1971, this figure was just over 20 per cent, with larger cities less likely to contract out.⁵

In Canada it was estimated that 42 per cent of municipalities had completely contracted out refuse collection by 1980, with a further 37 per cent using contractors to collect some residential waste (McDavid 1985).

Even prior to the introduction of compulsory competitive tendering (CCT) in the UK, refuse collection was commonly contracted out. Between 1980 and 1988, 34 local authorities contracted out the service, while a number of other

⁴ The figures for NSW and Victoria are close to those estimated by Rimmer for the same year, which were 64 and 63 per cent respectively (Rimmer 1993). The Evatt Research Centre also found that other elements of waste management services, including recycling and the collection of non-household garbage, were extensively contracted out.

⁵ The private sector also collected refuse under private collection, franchising or self-service arrangements (Savas 1977b).

councils tendered the service, but awarded the contracts in-house. The 1988 *Local Government Planning Act* made competitive tendering compulsory for refuse collection where the contract was over £100 000. The total value of refuse contracts was over £440 million by 1994 (Local Government Management Board 1994). Available evidence suggests that there has been significant competition for these contracts (see box C.1).

Refuse collection was also extensively contracted out in continental Europe by the early 1990s. In Germany it is estimated that as much as 75 per cent of refuse collection has been contracted out, covering approximately 50 per cent of the population.⁶ In France around 60 per cent of the population was serviced by contractors⁷, while in the Netherlands up to 40 per cent of municipalities contract out their refuse collection (Digings 1991).

Box C.1: Competition in the UK refuse collection market

A 1994 study by the Local Government Management Board suggested that the UK refuse collection market is highly competitive.

The number of contractors competing for contracts was fairly stable from 1989 to 1992, when the bulk of first round contracts were let. However the small number of recent contracts showed an increase in the level of competition. In the six months to August 1994, an average of 13 contractors (including in-house teams) applied to be on the tendering list for each contract let, with an average of 4.5 contractors actually tendering. Competition appeared to be strong in all regions, with little significant variation in the number of tenders for contracts. Over 90 per cent of current contracts were won in competition.

While 64 per cent of current contracts were won by in-house teams, there appears to have been some increase in the success rate of external contractors over time.

Source: Local Government Management Board 1994

C.3 Experience with CTC

C.3.1 Reasons for and against CTC

Many councils have found benefits in competitively tendering and contracting refuse collection.

⁶ It is not clear whether the 75 per cent figure refers to volume of garbage, number of councils or expenditure.

⁷ Compagnie Generale des Eaux first won the contract to empty the bins of Paris in 1921 (Miller 1991).

According to the Evatt Research Centre's 1989-90 survey of Australian local councils, the main advantages of contracting out sanitation services including refuse collection were listed by councils as cost reductions (cited by 96 councils) and avoiding the need to purchase plant (cited by 79 councils). Other major advantages included greater flexibility in general (and in working hours specifically), and the use of extra resources and equipment (Evatt Research Centre 1990).

The Commission has also found that refuse collection services may be competitively tendered to facilitate in-house workplace reform (see below).

The Queensland Local Government Association submitted that the increased use of competitive tendering has been encouraged by the growth of major private sector contractors in the waste management industry and the trend towards increasing mechanisation of collection procedures (Sub. 35).

While some councils have embraced the competitive tendering and contracting of refuse collection, others have been less enthusiastic. Most concerns have focused on the ramifications of external service provision. The Evatt Research Centre survey found the main disadvantages of contracting out sanitation services to be loss of direct control and accountability (cited by 58 councils), and the deterioration of quality (cited by 52 councils). Other commonly cited disadvantages included more difficult supervision, higher costs and poor public relations skills of contractors.

Another concern with contracting out refuse collection raised by several councils during the course of this inquiry was the possibility of supplier capture (see below).

Some groups have also raised concerns about the role of large multinationals in the industry, following allegations of strategic behaviour by large contractors in North America. Controversy surrounding these firms centred on charges of price-fixing, bid-rigging, connections with organised crime, and practices which were environmentally destructive (Fraser 1992).⁸ However, there has been no evidence of such behaviour in Australia.

C.3.2 The impact of CTC

The effects of CTC are wide-ranging. They touch on the cost of providing a service, the quality of services provided, employment levels and conditions, industrial relations and accountability.

⁸ To the extent that Australian garbage sites are largely owned and controlled by the public sector, the problems relating to *waste disposal* are less relevant.

Cost

As noted in chapter B3, the accurate measurement of the cost impact of CTC is a difficult task. The difficulty in obtaining information on many indirect costs has meant that they were not included in many of the studies discussed below (appendix E has a more detailed discussion of this point). This omission may affect the estimated costs of both internal and external provision, as well as the costs of the contracting process itself.

Despite the difficulties, there have been a number of studies both in Australia and in other countries on the cost impact of CTC in refuse collection.

Studies in several other countries have found savings from competitive tendering refuse collection ranging between 7 and 49 per cent of costs.⁹

Several UK studies, based on experiences prior to the introduction of compulsory tendering, found that CTC reduced costs by around 20 per cent. Savings were evident whether the contract was awarded to an external contractor or to an in-house team (Szymanski and Wilkins 1993, Domberger, Meadowcroft and Thompson 1986, 1988). Another study, based on experience after the introduction of compulsory tendering, found that CTC reduced costs by around 11 per cent (Walsh and Davis 1993).¹⁰

Several North American studies from the late 1970s and early 1980s also found significant reductions in costs associated with the private operation of refuse collection. Similar results were found in a study in Switzerland.¹¹

In response to an Australian survey conducted in 1988-89, 93 councils stated that the cost of sanitation services was lower when contracted out; only 23 found costs to be higher (Evatt Research Centre 1990).

Three studies conducted in Australia are reported in table C.1. They all found that the average cost of refuse collection was between 10 and 20 per cent lower for councils using contractors in the late 1980s. However, Rimmer (1993) found that, while the median cost of refuse collection was lower where contracted out in Victoria, it was higher in New South Wales.

⁹ The impact on costs over time is addressed below.

¹⁰ Refuse collection and building cleaning showed the greatest cost reductions of those services surveyed.

¹¹ For North America see Edwards and Stevens 1978, Savas 1977a, 1977b and 1981, McDavid 1985. For Switzerland see Pommerehne and Frey 1977. See appendix E for cost savings figures derived in each case.

Table C.1: Estimated cost savings from contracting out refuse collection — Australian studies

<i>Year</i>	<i>Study</i>	<i>Region</i>	<i>Technique</i>	<i>Cost impact (%)</i>
1985-86	Rimmer 1988a	Melbourne	Average cost	-17
1988	ACC 1988	SA and Tasmania	Average cost	-9
1988-89	Rimmer 1993	Victoria	Average cost	-18
		NSW	Average cost	-10
		Victoria	Median cost	-9
		NSW	Median cost	+6
		Victoria	Multiple regression	+7.5
		NSW	Multiple regression	(not statistically significant)

Sources: Rimmer 1988a, ACC 1988, Rimmer 1993

Rimmer also found, based on regression analysis, that there was no significant statistical relationship between contracting out and costs in New South Wales, and that contracting out actually increased costs by around 7.5 per cent in Victoria. These results suggest that estimates of cost savings are sensitive to the methodology used, and should, therefore, be treated with caution. For example, the lower average costs observed in these studies for councils contracting out refuse collection may be caused by factors other than the use of contracting, such as differences in population or geography.¹²

While overseas studies suggest that significant cost savings are derived from competitive tendering refuse collection, it is more difficult to make generalised conclusions based on Australian evidence. The cost impact is likely to vary on a case-by-case basis. Savings can be generated under the right circumstances, whether the contract is won by in-house or external teams.

For example, in the City of Port Phillip competitively tendering and contracting refuse collection in 1994 was said to save the community approximately \$180 000, or 20 per cent of the previous cost, for the 12 month contract period (Sub. 73).¹³ Savings from contracting out were also derived by the former City of Nunawading (Vic). Other local governments, including Melbourne and Oakleigh (Vic), derived savings through competitive tendering which resulted in the retention of the service in-house (see below).

The cost impact of CTC is likely to be influenced by a number of factors. A major determinant appears to be the level of competition for a contract. For

¹² This has important implications for other studies, as it suggests that results vary significantly according to the type of cost measure employed.

¹³ This was despite the fact that there was no competitive pressure from an in-house bid, and only 17 days were given for tender preparation.

example, in 1988, intense rivalry between Pacific Waste Management and Mosman Environmental Services led to the former submitting a bid well under those of its competitors to win the contract to collect refuse in Mosman Council (Domberger and Hall 1995).

The Local Government Association of Queensland claimed that the size of the local market is a critical determinant of the cost impact:

... rural councils may not necessarily gain cost advantages in contracting-out services such as refuse collection. For example, Banana Shire in Central Queensland called tenders for refuse collection and found that the private contractor price was considerably more expensive than in-house costs. The size of the local market is therefore a critical element. (Sub. 35, p. 2)

A US study by Edwards and Stevens (1978) provides support for this argument. It found that savings were greater for larger cities, where there was competition between bidders and economies of scale were attained.

Other determinants of the cost impact of CTC are likely to include the way the contract is specified and the tender conducted (see below).

Cost impact over time

There is little evidence available on the level of savings achieved over time from CTC in the refuse collection industry. There is some concern that the savings may dissipate due to supplier capture or 'loss-leading' behaviour in the first round of tenders (see chapter B3). However, even where studies provide evidence purporting to show savings from competitive tendering declining over time, this may reflect efficiency improvements in in-house teams driven by the threat of CTC.

In the UK, Ganley and Grahl (1988) suggested that some contracts may have been won using loss-leading behaviour. They cited the cases of South Kesteven, where the contractor applied for a 2.5 per cent increase in the value of the contract before its commencement, and Taunton Deane, where the contractor applied for a 13 per cent revaluation of its contract within the first year.

In a more in-depth UK study, Szymanski and Wilkins (1993) analysed cost savings over time using annual data on the costs of refuse collection by local authorities. The data covered the period from 1984 to 1988 and the sample included observations of contracting and internal provision in each year, allowing a comparison of costs at the same point in time.¹⁴ The authors found that the savings from contracting increased during the first three years, but then

¹⁴ See appendix E for a discussion of measuring cost savings over time using this 'moving base' approach.

began to decline.¹⁵ The authors attributed the increased cost savings in the second and third years to the reorganisation costs incurred by agencies during the first year of contracting. As the subsequent decline in savings coincided with the renegotiation of most initial contracts, the authors attributed it to deliberate or accidental underbidding in the first round. However, they also recognised that it may have been due in part to the falling real costs of providing the service internally (Szymanski and Wilkins 1993).¹⁶ To the extent that these reductions in costs of internal provision may have been driven by the threat of CTC, they may also be seen as an indirect gain from CTC.

A case study of waste collection in the City of Minneapolis (USA) demonstrates the potential for internal efficiency improvements to reduce the perceived gains from CTC (Savas 1977a). Comparing the costs of private contractors and internal providers for four separate years, the author initially found that the costs under private contractors were 13 per cent lower.¹⁷ However, four years later internal providers were found to be marginally cheaper. This was due mainly to a reduction in the cost of providing the service internally, rather than an increase in the cost of private provision. This may suggest that the introduction of competition, or the threat of its introduction, was sufficient incentive for the internal providers to reduce their costs.

In the City of Phoenix (USA), the Public Works Director claimed that the costs of solid waste collection had fallen by 4.5 per cent a year in real terms over a ten-year period. This was attributed to continuing competition, which forced the in-house team and contractors to find new ways to drive down costs (Osborne and Gaebler 1993).¹⁸

While no time series data on the cost impact of CTC in refuse collection is available in Australia, the Commission has found no evidence of supplier capture, loss-leading behaviour, or a significant reduction in competition for refuse contracts over time. Several councils which have contracted their services for over 15 years submitted that they still received a number of tenders for each contract let (Knox City Council Sub. 210, Brisbane City Council Sub. 219, Glenorchy City Council Sub. 229).

¹⁵ Based on yearly comparisons between contracting and non-contracting groups, savings from contracting were estimated as 26 per cent after one year, 35 per cent after three years and 21 per cent after four years.

¹⁶ Other possible explanations may include a reduction in competition for later tenders.

¹⁷ In this study the city's waste collection was divided between private contractors and the municipality's in-house providers.

¹⁸ For example, when the in-house team converted from 25 to 32 cubic-yard trucks, the private competitors quickly followed suit, forcing the in-house team to find a new competitive advantage.

Source of savings

Savings from CTC may come from a number of sources, such as greater labour and capital productivity, which may represent a better use of those resources, and reductions in wages or service quality (see chapter B3).

The only study specifically designed to identify the sources of efficiency gains from CTC in the refuse collection industry was carried out in the UK in 1987. The study found that roughly three quarters of the estimated 22 per cent cost savings from contracting out could be attributed to technical efficiency gains (greater productivity of labour and vehicles). In contrast, technical efficiency improvements accounted for only about 40 per cent of the 17 per cent savings from awarding the contract in-house under competitive tender. Changes in the vehicle-labour mix, reductions in overhead expenditures and reductions in wages and fringe benefits were identified by the authors as the possible sources of the residual cost savings (Cubbin, Domberger and Meadowcroft 1987).

In a study of 126 Canadian cities, McDavid found private collection crews to be 95 per cent more productive per person than their public counterparts. Private firms tended to use larger capacity vehicles and smaller crews, and offered more productivity incentives to workers. Salaries were also found to be around 10 per cent lower in private companies, though this was not held to be significant in driving savings (McDavid 1985).

Looking more closely at two cities, West Vancouver and Richmond, McDavid again found that cost savings were derived from significant increases in crew productivity. In the case of Richmond, the contractor used the same crews and vehicles as the previous internal team. However, the average number of trucks used per day was reduced and average tonnes per truck per day more than doubled, driving a 65 per cent increase in productivity (McDavid 1985 & 1988).

Several other overseas studies support the theory that savings from contracting refuse collection arise from productivity improvements.¹⁹

In contrast to the above studies, Ganley and Grahl (1988) produced anecdotal evidence from the UK that cost reductions from contracting out were achieved by reducing working conditions. Evidence cited included the case of Taunton Deane, where the working day was extended by two hours, the premises used by contractor staff had no toilets or canteen, and vehicles became unroadworthy. Other studies by SCAT (1988 & 1989) and Blunkett (1991), cited in Szymanski and Wilkins (1993), also suggested that service quality and working conditions had deteriorated following contracting out.

¹⁹ See Audit Commission 1984, Gears 1984, Szymanski and Wilkins 1993, Walsh and Davis 1993.

Evidence submitted to this inquiry suggests that efficiency improvements are an important source of savings derived from CTC in Australia. In the City of Port Phillip, the winning contractor reduced staff used from 25 to 15, and the number of trucks from eight to five. Trucks previously used for only five hours a day are now in action eight hours a day (Transcript, pp. 1606-8, ACTU Sub. 75). In the City of Melbourne, where the in-house team won the refuse collection contract, savings were generated by the implementation of new technology, changed work practices and better monitoring systems, and the reduction of staff levels by half (Transcript, p. 1462).

Pacific Waste Management submitted:

The savings are generally as a result of higher productivities and technological advancement. The move is from high manual content to high capital content. (Sub. 52, p. 5)

Although the Evatt Research Centre's 1988-89 survey did not ask councils the source of any savings derived from contracting out sanitation services, its results suggest several possibilities. The advantages of contracting out listed by councils included avoiding need to purchase plant, greater flexibility, administrative ease, greater productivity and lower labour costs. According to the Evatt Foundation, almost half of those who listed lower costs as an advantage of contracting also cited the disadvantages as service deterioration, loss of accountability or supervision problems (Sub. 143).

Quality

The quality of refuse collection encompasses a number of factors including the reliability of collection, rubbish spillage and noise levels. It is generally measured by the number of complaints received from residents. Particular care must be taken when analysing changes in quality to identify whether they are the result of the performance of contractors not meeting specified quality levels, or changes in the quality specified in the contracts.

A 1986 UK study found no evidence to suggest that savings from contracting out were achieved at the expense of the quality of the service provided. The analysis accounted for two aspects of service quality, method and frequency of collection (Domberger, Meadowcroft and Thompson 1986). These measures have been criticised by Paddon (1991), who claimed that both variables are determined by the terms of contract, and hence are unlikely to be varied by contractors. He considered that the real measures of quality include missed collections and spillage of refuse. As the original study noted, no aggregate information was available for these measures.

In another UK study, five authorities interviewed in 1985 felt that the same standard of service was provided by contractors as was previously provided by

internal providers. Penalty clauses for non-performance were considered sufficient to ensure the required standard of service (Meadows 1985 as cited in Domberger, Meadowcroft, Thompson 1986).

Evidence from a UK Local Government Management Board report in 1994 also suggests that most contracts for refuse collection in the UK were performed satisfactorily. Of the 437 UK refuse contracts analysed, 96 had experienced minor difficulties, 42 had encountered major problems leading to financial penalties, and only 11 were terminated. Significantly more problems were encountered with contracts awarded to in-house teams, which accounted for 10 out of the 11 contract terminations, and the majority of reported problems.

A few UK studies have focussed on cases where a poor quality of service was provided by external contractors. For example 30 000 complaints were received in the first 15 months of private contracting in the Wirral, while penalties totalling £45 000 were levied on the contractor in Wandsworth for poor performance in 1983 (Ganley and Grahl 1988, see also Trades Union Council 1984).

In the USA, a study by Stevens found no significant difference in the quality of service provided by public and private contractors (Reason Foundation 1994b).

In Australia there are some cases of refuse collection services deteriorating following contracting out, but there is no evidence of a consistent impact on service quality. In some cases service quality has improved.

In a 1988-89 survey of Australian local government, 52 councils stated that the quality of sanitation services (including refuse collection) was lower when contracted out, while only nine found that it was higher (Evatt Research Centre 1990). However, it should be noted that this represented only 11 and 2 per cent of total survey respondents respectively, with the balance not listing quality changes as a disadvantage or advantage of contracting out. Thirty-eight councils stated that they had returned to day labour after using contractors in the sanitation services area.

In some cases, consistently poor service quality has been experienced following contracting out. For example, in Calliope Shire (Qld), customer complaints about the quality of service provided by a contractor were so serious that the Council commenced procedures to revoke the contract. The Council suggested that, as legal processes take time, there would be delays in maintaining an efficient service to the customer (Sub. 15).

In other cases, problems with service quality appear to have been a transitional issue, with the quality falling temporarily during the initial bedding-down of the contract. In the City of Port Phillip (Vic), the contractor took about a month to

bed-down the service, during which time a large number of complaints were received.²⁰ According to the City of Port Phillip:

Notwithstanding the initial bedding-in process, residents continue to receive a good domestic waste collection service and are now receiving a significant increased benefit through the introduction of a regular hard waste collection service. (Sub. 73, p. 3)²¹

The contractor (Cleanaway) commented:

... since mid January 1995, the level of complaints has reduced dramatically and it is now common for ratepayers to congratulate our employees on the service they are providing. (Sub. 206, p. 2)

The quality of service may also be affected by industrial disputation, as refuse is left to accumulate when workers walk off the job. This was a major problem in Doncaster-Templestowe (Vic) in 1988, and Adelaide (SA) in 1994. However industrial disputes have also been a problem with internal service provision (see below).

In some cases it is difficult to determine how quality was affected by CTC. Sutherland Shire (NSW) claimed it received a steady stream of complaints about missed services and early noise on weekends following contracting out. The number of missed services reportedly fell when the service was returned to day labour in late 1992. However, the contractor disputed the frequency of complaints, conducted a survey showing widespread satisfaction with the service, and produced a letter of praise for garbage drivers (Woodland, Swords and Hall 1994).

Overall, overseas experience suggests that contracting out has no significant impact on the quality of the service provided, while there is little evidence to suggest it has been a problem in Australia.

Employment levels

Available evidence suggests that direct employment on particular services is often reduced when refuse collection is competitively tendered, whether the service is contracted out or remains in-house. However these employment reductions may be driven by factors other than CTC.

²⁰ The adjustment phase was made more difficult as it coincided with Christmas, a heavy period for refuse collection. The City of Port Phillip claims that the number of complaints received was also inflated as residents were unaware that their bins would not necessarily be collected as early in the morning as was previously the case.

²¹ As two of the three councils which were amalgamated to form the City of Port Phillip did not keep records of the number of complaints received, no comparison of the quality of the service is possible on that basis.

In the UK tendering appears to reduce employment on particular services regardless of whether external or in-house teams win the contract. One study estimated that the number of employees was 25 per cent lower for private contractors, and 19 per cent lower for in-house teams that won tenders, than for councils which did not tender the service (Szymanski and Wilkins 1993). The impact was greater in South Kesteven and Taunton Deane, where almost half of the direct labour was made redundant when the contract was outsourced (Ganley and Grahl 1988).

A more recent UK study found that employment in refuse collection was reduced by an average 23 per cent following CTC.²² However, the study noted the difficulty in quantifying the extent to which these reductions were caused by CCT, due to the possible additional effects of restructuring, budget cuts and technology changes (UK Equal Opportunities Commission 1995).

Although no extensive studies are available for Australia, there appears to be a reduction in direct employment whether the service is contracted out, won in-house under competitive tendering or internally restructured as an alternative to CTC.

In the City of Port Phillip, refuse collection staff were reduced from 25 to 15 when the service was contracted out (ACTU Sub. 75).²³ In the City of Melbourne, staff were reduced by half in preparation for tendering (Transcript, p. 1462). In Strathfield (NSW), refuse collection staff levels were reduced by one third in reforms introduced as an alternative to tendering (Strathfield Municipal Council 1995).

Pacific Waste Management observed that, while competitive tendering is associated with significant employment reductions, care must be taken to account for the impact of other factors such as technological advancement.

In the area of waste management contracting out has very little impact on employment levels. However, in recent years there have been advances in technology in the waste industry which have had impact on employment levels. These impacts are most noticeable at the time of transferring the work from the public sector to the private sector after successfully winning a tender. (Sub. 52, p. 5)

This view is supported by the case of the City of Melbourne, where staffing cuts corresponded with the move from manual filling of trucks to mechanised bin lifting before the service was tendered (Transcript, pp. 1461-2).

²² The study covered 39 local authorities, though it looked at refuse collection for only 26 of them.

²³ Staff were initially cut to 10, but this proved unsustainable after only one day.

In some cases, the impact of contracting on staff levels is determined by contract clauses dealing with the transfer of council staff. In Sutherland Shire, the contractor was required to make permanent job offers to all the Council's existing garbage employees (Woodland, Swords and Hall 1994). Though its refuse contract was eventually won in-house, Manly Council's tender specification required that external contractors offer employment to council staff for 80 per cent of their staffing requirements. However, in-house staff were not obliged to transfer to an external contractor if one was successful, and could opt to remain employed by the Council (Domberger and Hall 1995).

Conditions of employment

CTC often affects workers' conditions by facilitating internal workplace reform, or because workers move to the conditions agreed with an external contractor or the private sector award. In some cases, conditions may only be affected during the initial stages of contracting as the contract is bedded-down.

CTC may facilitate the introduction of workplace reform, resulting in changed conditions for workers. For example, significant internal reforms were implemented in the cities of Melbourne and Oakleigh in preparation for competitive tendering (see below).

There is some evidence that contracting out has resulted in longer work hours for employees but this appears to have occurred primarily in the initial stages of a contract as teething problems are sorted out.

The ACTU claimed that staff transferred to the contractor in the City of Port Phillip have experienced a deterioration in working conditions.

Due to the under-resourcing of the bid, workers are working significant overtime on every single collection day in order to complete the round. Overtime for each worker of 3 to 4 hours per day is not uncommon. This has led to high levels of staff turnover as the burn-out rate of staff is high. There are clearly health and safety dangers for employees working these sorts of hours. (Sub. 75, p. 70)

However, the contractor informed the Commission that the claim was incorrect:

This is totally false, whilst overtime was high during the early stages of the contract, the average overtime worked is 1-2 hours per employee per week. (Cleanaway Sub. 206, p. 2)

Similarly, in Sutherland Shire drivers were required to work longer working days (sometimes up to nine hours) during the initial stages of the contract as a new collection system was gradually introduced (Woodland, Swords and Hall 1994).

The Commission has received little information on Australian experience with the impact of contracting on workers' remuneration. In the Evatt Research

Centre's 1988-89 survey, only 12 councils cited lower labour costs as an advantage of contracting out sanitation services. Overseas evidence suggests that wages may rise or fall following competitive tendering, with both potentially offset by changes to fringe benefits.

A 1994 UK study found that pay levels of refuse collection workers had increased since the service was first subject to CCT. Almost all local authorities examined maintained National Joint Council rates, and almost half of the separate trading units established to bid for contracts improved bonus schemes in return for more intensive work and higher productivity levels. In some cases the pay of collectors and drivers has doubled (UK Equal Opportunities Commission 1995).

In a study of 126 Canadian cities, McDavid found that wages were around 10 per cent lower in private companies than in councils (McDavid 1985). Berenyi cited several cases where workers' fringe benefits were reduced, though in at least one case this was accompanied by a wage rise (Berenyi 1981).

Industrial relations

Several councils indicated to the Commission that improved industrial relations were a major advantage of contracting out refuse collection. Similarly, in the UK before the introduction of CCT, contracting out of garbage collection was said to be commonly driven by a desire to avoid recurring industrial relations problems (Ascher 1987). In Richmond (Canada), an area-wide strike was a key factor in the decision to tender (McDavid 1985).

However, CTC has sometimes resulted in increased industrial disputation. In 1988 garbage collectors in Doncaster-Templestowe (Vic) walked off the job after the contractor ended an over-award site payment that had existed under previous contractors (Evatt Foundation Sub. 143). In 1994, six Adelaide suburban councils were reportedly affected when 30 transport workers went on strike for a week over a bid by Pacific Waste Management to introduce owner-drivers into another municipality (The Advertiser 1994).

While no recent figures are available, in a 1988-89 survey 22 councils cited less industrial relations problems as a benefit of contracting out sanitation services, while 8 cited increased disputation as a problem (Evatt Research Centre 1990).

Accountability

One issue often raised is the impact of CTC on the accountability of local councils for the provision of adequate refuse collection services.

The Local Government Association of Queensland suggested:

In local government contracting-out, the confusion over accountability does not appear to arise. This is primarily because of a locally elected representative body which cannot escape being seen as the first point of contact on community concerns with services. While a refuse collection service may be contracted out, it is typically the council that receives the complaints when a bin is missed by a contractor and who must take action to rectify the problem. (Sub. 35, p. 6)

This view is supported by an incident in Sutherland Shire, where a resident ultimately took his bin to the Council offices and left it to be emptied when it was not collected by the contractor (Woodland, Swords and Hall 1994).

Calliope Shire Council supported the view that the community holds the council responsible for the service, and not the contractor (Sub. 15). The Director of City Development at the City of Glen Eira (Vic) has suggested that where there is disruption of service provision:

Customers become quickly dissatisfied with the failure of a basic and regular service, media attention is immediate, a political price is usually paid and responsible staff cannot escape unscathed. (Hawke 1995, p. 2)

There have been some cases where councils appear to have been reluctant to assume responsibility for problems in service provision. For example, the Evatt Foundation claims that when an industrial dispute broke out in 1988 between a refuse contractor and staff in Doncaster-Templestowe:

The council refused to intervene or take any responsibility for the dispute, saying it was a matter for Otto Australia and the relevant union, the Transport Workers Union, but as a result the situation deteriorated. (Sub. 143, p. 11)

A strike and subsequent 'go-slow' campaign resulted in the accumulation of household refuse for several months before the dispute was eventually taken to arbitration.

However, as the Evatt Foundation also noted:

The Mayor and a number of Councillors were not re-elected in the local government elections that took place in August, a result that was, at least in part, an electoral move against the 'cheapest bid' policy of tendering that the council had adopted. (Sub. 143, p. 11)

C.3.3 Factors affecting impacts

Tender and contract specification

The terms of refuse collection tenders and contracts vary in a number of different ways which can affect the success of CTC.

Coverage

Councils may choose to tender refuse collection in the whole jurisdiction, or divide it into geographical segments for separate tender. Dividing the service for separate tender may encourage competition and allows the council to retain part of the service for security. However, this may prevent the utilisation of economies of scale.

A 1995 survey of 151 Australian councils found that about a third of councils used both an in-house team and contractors to collect refuse (Waste Management and Environment Magazine 1995). In the City of Minneapolis (USA) the council divided the city into eleven districts and separately contracted out the refuse collection service for each. To allow for maximum competition, no firm (including the in-house team) could be awarded more than three of these districts. In addition, one district was reserved for an in-house team, which served to affirm to residents and city officials that the city would be able to keep collecting garbage if necessary (Reason Foundation 1994b).

Tender lead times and contract length

The time allowed for the preparation of tenders and the specified length of contracts, can also affect the cost savings derived from competitively tendering and contracting refuse collection.

Pacific Waste Management gave examples of several cases where under three weeks was given for the preparation of tenders. In the Shire of Bacchus Marsh (Vic), only eight days were given from the advertisement of tender to the closing date. The company submitted:

In order that well conceived and accurate tenders are submitted, adequate time should be given from the time of calling the tender to the closing date. ... PWM's experience in the industry indicates that if justice is to be done to a tender a minimum of 30 days is required between the time of advertising the tender and the closing date. Short lead times often are used to ensure that only 'desired' companies tender thus making the whole process a sham. (Sub. 52, pp. 8-9)

A number of factors influence optimal contract length, including the need to allow contractors an adequate return on any investment and the need to avoid locking the council into a contract which will become outdated or unnecessarily restrict council policy. Optimal contract length is likely to vary according to the particular circumstances of each case.

The length of refuse collection contracts let in Australia appears to vary substantially. For example the contracts in the cities of Unley (SA) and Port Phillip (Vic) are for 10 years and one year respectively.²⁴

Some participants considered that longer contracts are necessary because of the capital intensity of the industry and thus the need to allow time for the realisation of a return on investment. Pacific Waste Management advocated contracts for a minimum of seven to 10 years and the inclusion of options for extension (Sub. 52). Both Knox (Sub. 210) and Brisbane City Council (Sub. 219) supported longer contracts.

However, the need to allow adequate time for the recoupment of investment will depend on who owns the capital equipment used in service provision and the market for such equipment. If the contractor is leasing the equipment (from the council or a third party), or if there is a strong resale market for the equipment, long contracts may not be needed.

While long contracts have some advantages, they may lock a council into paying for a service which becomes outdated. The City of Unley (SA) has found its 10 year contract term too long:

The contract has four years to run, and clearly the factors that determined the pricing structures in the contract six years ago no longer apply; the methodologies and the base criteria have changed. The result is that Council is currently paying an excess on this contract as opposed to contracts being negotiated based on market trends and market factors of today. Unley's experience suggests that contracts should not be long term or if there is a need, given the asset purchase as disbursement of upfront charges in contracts, there should be a revision clause for market testing on either an annual or bi-annual basis. (Sub. 86, p. 1)

Glenorchy Council (Tas) took the changing nature of waste management services into account when it last tendered a contract for refuse collection and decided on a five-year rather than ten-year period. It was concerned that, for example, mobile bins may no longer be appropriate if kerbside recycling was introduced (Sub. 229).

Long-term contracts may also restrict a council's freedom to formulate waste management strategies. For example, long-term contracts that embraced 240 litre bins for domestic waste collection may affect the ability of councils to encourage waste minimisation (Hawke 1995).

Johnstone Shire Council (Qld) emphasised the need to strike a balance between allowing cost recovery and avoiding an excessively long contract term. One option the Council suggested was the use of renewable terms subject to

²⁴ While no aggregate data is available for Australia, in the UK the average length of contracts let in the five years to 1994 was 5.6 years (LGMB 1994).

performance in the initial term. This would provide a safeguard for both government and contractor (Sub. 17).

In some cases, special circumstances may make it optimal to let very short contracts. For example, following amalgamation, the vast majority of refuse collection staff in the City of Port Phillip accepted voluntary departure packages. Faced with the need to quickly find an external contractor to provide the service, it decided to let a contract for only 12 months, during which time it could reassess the contract specifications (Transcript, p. 1606).

Treatment of assets

Councils have taken several approaches to dealing with assets when refuse collection is contracted out. Trucks and bins may be sold or retained, and sometimes leased.

There is widespread concern among councils that contracting out garbage collection and selling collection vehicles will lead to the creation of a monopoly supplier. Once a council has sold its trucks in such a capital-intensive industry, it is feared that the contractor would be free to raise its price in the second round of contracts given the significant costs associated with returning to in-house provision. The New South Wales Local Government and Shires Association reported that there have been cases of companies raising prices over time, until it has been more economic for the council to go back to direct service provision. This has proved difficult (Transcript, p. 901). Councils have also questioned how they could ensure the service is provided to rate payers if the contract is not fulfilled.

The risk of supplier capture is greatly reduced, and ramifications of contract failure ameliorated, where it is possible to lease the capital equipment. For example, the lack of in-house equipment has not been seen by Glenorchy Council (Tas) as a significant barrier to returning to in-house provision. In 1990, eleven years after the council first tendered its refuse collection, the council submitted its own bid to do the work. The council claimed that it would have no problem in acquiring the necessary resources to undertake the work, pointing out that the current contractor itself leased the trucks used (Sub. 229).

The risk of supplier capture or contract failure can also be dealt with by setting up appropriate safeguards. The City of Port Phillip has retained ownership of its rubbish trucks and leases them to the current contractor (Transcript, p. 1608). The City of Melbourne has a policy of not selling assets valued at more than \$50 000. Thus, the large compactor trucks (valued in excess of \$100 000 each) used for refuse collection would remain in the Council's ownership if refuse collection were contracted to external providers. Assets would be leased to

providers if they required them, or alternative uses found for those assets during the preliminary term of contracts (Sub. 89).

An alternative approach has been to retain the money from the sale of collection vehicles in a fund that could be used to purchase or lease trucks if the city decided to return to in-house provision. This was the approach taken by the Canadian Council of Halifax (Canada) and was proposed by Manly City Council (NSW) if the tendering of its refuse collection services had been won by an external contractor (McDavid 1985, Domberger and Hall 1995).

Contract flexibility and innovation

The specification of requests for tender and contracts may have an important impact on flexibility, the development of innovative practices and the introduction of new technology.

Requests for tender may specify the means by which refuse is to be collected, or just the service to be provided, leaving the contractor free to choose the method of collection. Pacific Waste Management suggested that open tenders provide more scope for innovation. In particular, it considered there is a tendency to be over-prescriptive in tenders where an existing service is being replaced (Sub. 52).

The Director of City Development of the City of Glen Eira (Vic) suggested:

The role of the contractor in reducing cost is to be innovative within the essential constraints of the contract. The role of the client is to avoid encumbrances and unnecessary constraints on the contractor. (Hawke 1995, p. 3)

For example, constraining the earliest time for collection reduces the number of bins that can be collected in a day. This may be appropriate in a residential area sensitive to noise, but less applicable in industrial areas or on busy arterial roads. Seemingly minor changes, such as allowing earlier collection in some areas, may generate significant savings by reducing the number of compactors required for a contract (Hawke 1995).

The former City of Nunawading (Vic) provides an example of the potential gains from reducing the constraints within which contractors must operate. The City specified that subcontractors could be used with permission, which was not always granted by other municipalities. This clause was crucial in attracting the winning contractor to bid, resulting in substantial savings without any reduction in quality (Hawke 1995).

In preparing requests for tender, the City of Melbourne places strong emphasis on inviting responses which demonstrate a capacity to offer innovative service delivery options and flexibility throughout the term of the contract (Sub. 89).

Problems may arise where the parties to a contract have different expectations as to the flexibility of its interpretation (see box C.2).

Workplace consultation

The support of the workforce and unions is often a significant factor enabling successful CTC in refuse collection.

Box C.2: Expectations of contract flexibility in Sutherland Shire (NSW)

The contract for refuse collection in Sutherland Shire specified restrictions on the hours during which refuse could be collected and the method of collection to be used. Soon after signing the contract, new one-person trucks began to be introduced into the industry. The contractor proposed to phase in these trucks, which were seen as more efficient, less cumbersome and far less prone to breakdown. This change was opposed by the Council, which thought the existing technology provided the most efficient system of collection. The contractor also proposed the variation of working hours, which was also refused by the Council. Neither change was introduced.

While the contractor had expected the contract to be a 'parameter' document that could be adjusted as problems arose, the Council saw it as a carefully considered document with conditions negotiated and agreed upon by both sides prior to signing.

Source: Woodland, Swords and Hall 1994

According to its Chief Executive Officer, Oakleigh City Council (Vic) was committed to an open consultative approach to the reform of its refuse collection service. Collectors were encouraged to choose their own representatives to join the review group, which also included representatives of the Municipal Employees Union. Managers of the relevant areas were also involved, as was the chief executive for the critical phases. The Council encountered no problems with industrial action, despite considerable tension (Halliday 1994).

The City of Melbourne also found that consultation with the workforce was important to the success of CTC:

... an enormous contribution was made, not only by analysis and careful preparation and corporate management action and discussion at that level, but by an enormous effort of will and willingness to change on the part of the workforce, led and supported by the trade union representatives, but which emanated from a feeling of trust in the medium-term bargaining. We made clear the expectations at the beginning, and they were held to. I think that is an important part of allowing people in this environment to actually be clear about what the medium term is, and not just about where we are in short-term processes, rushing around and evaluating things. (Transcript, p. 1463)

Quality assurance, performance monitoring and incentives

Another key factor in the success or otherwise of CTC is the establishment of systems to ensure that the quality of service provision is maintained. Quality assurance practices, such as requiring accreditation or certification of tenderers, reduce the chances of inappropriate contractor selection. Performance monitoring ensures that agreed standards are being attained. Penalties/rewards increase the incentives for contractors to maintain these standards (see chapters C6 and C7).

Brisbane City Council adopts a quality assurance approach when tendering refuse collection. The Council issues a statement of preference for certified Quality Assurance systems in tender documents.²⁵ Tenderers not so certified are required to produce a management structure, inspection procedures and checklist to demonstrate their ability to manage quality (Sub. 219).

While the Commission has received no evidence on the use of quality assurance at an aggregate level in refuse collection, in Victoria it has been suggested that few, if any, councils have required formal quality accreditation to ISO9002 (Hawke 1995).

Knox City Council (Vic) has adopted a comprehensive approach to ensuring the provision of a quality service, using performance monitoring, penalties and termination clauses (see box C.3). A similar system has been adopted by Glenorchy City Council in Tasmania (Sub. 229).

Penalties for substandard service provision were also specified in a contract for refuse collection in Sutherland Shire (NSW). The contractor was penalised \$200 for each missed service and overweight truck, with further penalties for leaving garbage in trucks overnight (Woodland, Swords and Hall 1994).

Another type of 'penalty' that may be used to ensure the provision of quality services is a performance bond. Pacific Waste Management advocated the introduction of performance bonds and environmental impairment bonds (Sub. 52).

Box C.3: Ensuring quality in the City of Knox (Vic)

The City of Knox has adopted a number of measures aimed at ensuring the quality of service provided is maintained once a contract is let. Performance is measured daily through calls to the council about missed bins, response to bin repairs, customer service and general enquiries to council. These calls are also recorded on a monthly and yearly basis by type of complaint,

²⁵ The Council notes that it is arguable whether this requirement has provided a benefit to the council.

to enable monitoring of the contractor's performance over time. Penalties are specified for non-performance, as are termination clauses, should the contractor fail to meet its obligations.

Source: Sub. 210.

Competition

There are several examples of significant savings being achieved when in-house teams win competitively tendered contracts. This suggests that in many instances competition itself is the essential force behind improvements in efficiency.

In Phoenix (USA), significant internal reforms were implemented in the refuse collection area after the in-house team lost the first four contracts competitively tendered after 1978. The Council converted from three-person to one-person trucks with mechanical arms which picked up bins and expanded the capacity of trucks. Drivers were asked to redesign routes and work schedules and teams were established to come up with other improvements to work practices. Employees were given ten per cent of the savings generated by their suggestions. Monthly and quarterly awards were given to the best drivers. A cost accounting system was adopted to identify the precise cost of service per household per month. Constant monitoring ensured that problems were addressed quickly, and provided a detailed data base for future estimating and tendering purposes. The in-house team won all subsequent contracts and, by 1989, provided all collection services in the municipality (Robins 1989 and Osborne and Gaebler 1993).

The City of Melbourne has also used competitive tendering to achieve substantial internal reforms (see box C.4).

Though Strathfield Shire Council (NSW) did not competitively tender its refuse collection service, it stressed the need for its staff to demonstrate that the service provided internally was at least as efficient as was available externally. The Council obtained the winning tender for a similar service in a nearby municipality to use as a benchmark. The council and staff then negotiated a range of reforms to achieve a similar performance. The rationalisation of staff, equipment, working patterns and processes led to significant efficiency gains. Staff levels and truck numbers were reduced by a third each. Average work hours were extended from 4-8 am to 4-11 am, and the foreman was issued with a mobile phone to enable the faster notification and replacement of absent staff, minimising down time. Collection was re-routed to reduce time and the residents of flats were requested to put their bins at the kerbside. Garbage staff

received a 9 per cent increase in salary subject to their agreement to reforms, and costs fell by 17-20 per cent (Strathfield Municipal Council 1995).²⁶

²⁶ These cost reductions were also achieved even though garbage staff agreed to take on the additional duties of collecting park and street litter bins, which were previously performed by other staff.

Box C.4: City of Melbourne

In 1990, refuse collection was one of the least efficient services provided by the City of Melbourne. Work practices were inefficient, capital equipment poorly used, absenteeism rife, management relations poor, and industrial disputation a significant problem. The technical basis of service was described as archaic, with manual lifting generating many back injuries and a log of work cover claims.

A benchmarking study was commissioned to compare the City's performance with 15 other refuse collection services, covering a range of forms of provision and technical bases for the service. The study showed the City's service to be the most costly and least effective.

A deal was struck with employees and management that, unless specified objectives of efficiency improvements were achieved within three years, the service would be contracted out without an in-house bid.

A new waste management transfer station was built, staff levels halved, and new work practices and monitoring systems introduced. The service was eventually put to tender, and the contract awarded in-house from among 20 bidders, including some of Australia's biggest waste management companies.

Source: Transcript, pp. 1462-3.

Similar internal efficiency gains were achieved in Traralgon (Vic) under informal market testing. Rather than competitively tender the service, the Council compared its costs with the successful tender in a similar council area. The Council also asked that tenderer and its own in-house team to submit a quote for the provision of Traralgon's refuse collection service. The service was contracted to the in-house team, whose bid was based on maintaining the same service but replacing old three-man trucks with new solo compactors. Savings of approximately 30 per cent were generated (Woodland and Hall 1994).

Box C.5 gives an example where, even after internal reforms have been implemented, additional savings may be won by exposing in-house teams to competition.

Box C.5: The City of Oakleigh (Vic)

The City of Oakleigh adopted a two-stage reform process after comparisons showed its refuse collection costs to be the highest in the region in the late 1980s.

In the first stage, which began in January 1990, changes in work practices were negotiated with staff and unions. The number of collector staff was reduced from 30 to 18, and a 19 day month replaced by a 9 day fortnight. In the second stage, the Council invited tenders for the domestic garbage service in December 1991. The Council indicated a preference for in-house provision, on condition that staff would guarantee to operate solo vehicles and hold variable costs (principally labour costs) steady. Staff and unions agreed to these terms, which were then set down in a formal enterprise bargaining agreement. As a result, by August 1992 eight collectors were doing what 18 collectors had done before competitive tendering, and a safer system of collection had been established.

Savings of the order of \$780 000 a year were achieved by the end of the second stage.

Source: Halliday 1994.

C.4 Conclusion

Although the cases of local authorities in Australia and overseas reveal many differing experiences with competitively tendering refuse collection, some general conclusions can be drawn.

CTC has often resulted in savings, though there are cases where costs have increased. This suggests that CTC has the potential to generate savings, but its effectiveness varies with the ability of each council to manage its implementation, and the circumstances of each case.

Competition is a major driving force behind successful CTC. Savings can be achieved whether the contract is won by in-house or external teams. The savings are driven by improvements in efficiency, including workplace reform.

Service quality does not necessarily fall as a result of CTC and, indeed, may turn out to be better than specified. Performance monitoring, penalties and termination clauses may be useful mechanisms to ensure the maintenance of quality. Accountability for the satisfactory provision of services cannot be contracted out.

CTC does appear to result in reduced direct employment in refuse collection, though this may also be partly caused by the introduction of new technology.

In the CTC process (including contract specification), particular attention should be paid to flexibility and innovation, optimal contract length and treatment of assets.

**APPENDIX D SURVEY OF COMMONWEALTH
BUDGET-FUNDED AGENCIES**

**GRADUATE SCHOOL OF BUSINESS
THE UNIVERSITY OF SYDNEY**

**Competitive Tendering and Contracting
in
Commonwealth Government Agencies:
1995 Survey Findings**

S. Domberger, C. Hall, and M. Jeffries.

Results of the 1995 survey of contracting activity carried out for the Industry Commission by the CTC Research Team, Graduate School of Business, The University of Sydney.

September 1995

**Graduate School of Business
The University of Sydney
Sydney NSW 2006
AUSTRALIA**

Executive Summary

This report provides an analysis of the results of a 1995 survey of competitive tendering and contracting by Commonwealth Government budget-funded agencies. The survey was designed to gather information on the extent, nature and performance of contracts. Recent surveys of contracting in New South Wales, Western Australia and Victoria were used as points of reference for benchmarking across different jurisdictions.

The project related specifically to contracts for services valued at \$50 000 or more and did not include capital works and construction projects, nor the purchase of goods. In order to report more accurately on the full extent of contracting, agencies were also asked to provide aggregated data for multiple contracts where it was not possible to identify single contracts and small multiple contracts within a particular service category which collectively exceeded the \$50 000 limit.

The survey was sent to 126 Commonwealth budget-funded agencies. However, due to the size, diversity and complexity of the data collection process many agencies were unable to participate.

In total 43 agency returns were included in the survey results. However, not all agencies could provide information on the full extent of their contracting activity. For example, the Department of Defence data was based only on services contracted under the Commercial Support Program (CSP) and consequently under-reported the extent of services contracted by Defence. Nor were agencies able to supply data for every question in the survey and the sample size for analysis varied accordingly.

The key findings of the survey are as follows:

- forty-three Commonwealth Government agencies let contracts with a combined value of \$1 853 million in the financial year 1994-95.
- the agencies with the highest value of contracted services were the Department of Veterans' Affairs (\$825 million), the Department of Employment, Education and Training (\$303 million), the Department of Defence Commercial Support Program (\$162 million), the Department of Administrative Services (\$151 million) and the Department of Social Security (\$134 million);
- activities with the highest value of contracting expenditure were contract staff (\$804 million), programme services (\$193 million), information technology (\$172 million), training, development & education (\$119 million), transport management & services (\$109 million), research, scientific & technical services (\$75 million), facilities management (\$37

- million), financial management (\$35 million), hospitality & catering (\$32 million) and cleaning (\$32 million);
- a total of 33 service categories showed some degree of contracting. These services covered a wide spectrum of government activity, indicating that contracting is being used in both core and non-core areas;
 - services contracted include activities performed by private, public and not-for-profit contractors and in-house teams. The contractor type was private in 64 per cent of cases. Public contractors, including government agencies or government trading enterprises (GTEs), was the second most popular type with 19 per cent. Not-for-profit contractors made up the remaining 17 per cent of cases. Only 10 per cent of contract cases included bids by in-house teams. Of these bids, only 15 per cent were successful;
 - public tenders were the preferred method for selecting a contractor in 38 per cent of cases. Inviting several firms to bid was the next most popular method, occurring in 26 per cent of cases;
 - the single most highly rated reason for contracting was effectiveness. This was rated as very important in 48 per cent of cases. Efficiency was rated as very important in 29 per cent of cases. Other reasons, including government directives, lack of expertise, budget directive and resource constraints rated (collectively) as very important in 85 per cent of cases;
 - an assessment of contracting outcomes indicates that on the whole agencies were satisfied with the outcomes achieved. The majority of cases reported outcomes as being very successful (15 per cent) or successful (58 per cent). It would appear that this was achieved without affecting quality of service. Compared with expectations, this was rated as much better or better in 50 per cent of cases;
 - the 609 responses that included information relating to current contract and management costs showed that average management cost for a contract was 2.32 per cent of the contract value;
 - savings were calculated from three sub-samples of the data. The average net savings was based upon the total of estimated annual cost prior to contracting less the corresponding total of the combined cost of annual contract fees and estimated contract management costs per annum. The average gross savings was based on data where management costs were not identified; and
 - average net savings (ie net of management costs) could be calculated from 51 contracts. It was 16.3 per cent. The average gross savings was 35 per cent for Commercial Support Program contracts and 18.1 per cent for non-

Defence contracts. The average gross savings was based on sample sizes of 49 and 74 contracts respectively.

Comparisons with other jurisdictions indicated that:

- there were strong similarities in the types of services contracted by agencies in different jurisdictions;
- in absolute terms, contracting by the Commonwealth appeared to be greater than in those states for which survey results are available. The total value of contracts reported by the Commonwealth was \$1.8 billion, followed by New South Wales with contracts valued at \$1.06 billion in 1994 and Western Australia with \$365 million, also in 1994;
- in-house bids were rare in Victoria and occurred in less than one per cent of cases in New South Wales. They were, however, more frequent in the Commonwealth, where ten per cent of all bids were from in-house teams. This suggests that competition between the public and private sector is limited in scale and scope;
- the importance attached to efficiency and effectiveness as a reason for contracting varied. New South Wales, Western Australia and the Commonwealth all rated effectiveness as the single most important reason. It was rated as very important in 66 per cent, 57 per cent and 48 per cent of cases respectively in New South Wales, Western Australia, and the Commonwealth. Efficiency was rated as very important less frequently with Western Australia (57 per cent) being the highest, followed by New South Wales (54 per cent). A relatively small number of Commonwealth agencies indicated that efficiency was very important (29 per cent). However, other reasons were very important for 85 per cent of Commonwealth cases compared with 56 per cent for New South Wales and 62 per cent for Western Australia;
- only the Commonwealth and Victorian surveys separately identified management costs, although the Western Australian survey for 1995 included management costs as part of the total annual contract cost; and
- after adjusting for differences in methodology, the highest average net savings were reported in Victoria (37 per cent), followed by the Commercial Support Program (35 per cent), Western Australia (18-24 per cent), New South Wales (18-19 per cent) and the Commonwealth (16 per cent).

D.1 Introduction

In December 1994 the Industry Commission was asked by the Federal Government to conduct an inquiry into competitive tendering and contracting (CTC) by public sector agencies. The inquiry was to cover CTC by Commonwealth, state and local government departments and other agencies.

An inquiry issues paper defined contracting as ‘an arrangement whereby a government body enters into a contract with an external or government supplier (including an in-house supplier) for the provision of goods and/or services. Contracting is generally associated with competitive tendering: a process where bids are called for the supply of goods or services and a winning tenderer is selected on the basis of specified criteria such as cost and quality of service’.¹

The Commission was asked to report on:²

- the nature, extent and scope of contracting by public sector agencies;
- the costs and benefits of contracting, including the impact on government bodies with respect to value for money, quality of service and accountability;
- past successes and failures of contracting;
- the effectiveness of existing mechanisms for contracting;
- the implications for employees and their terms and conditions of employment; and
- the development of a set of indicative principles for public sector managers to use in assessing the scope for contracting.

As part of the inquiry, the Graduate School of Business at the University of Sydney was commissioned to undertake a survey of contracting by Commonwealth budget-funded agencies in the 1994-95 financial year. This report details the results of the survey.

D.1.1 Purpose and scope of the survey

The survey was designed to provide quantitative and qualitative information on the extent and experience of competitive tendering and contracting for services by Commonwealth budget-funded agencies. The data provided would supplement information on the nature, extent and scope of contracting by State

¹ Industry Commission, *Contracting Out by Public Sector Agencies: Issues Paper*, January 1995, p. 5

² Ibid p. 5

governments. In particular, recent surveys of contracting in New South Wales and Western Australia, also conducted by the CTC Research Team, and Victoria, conducted by the Victorian Office of Public Sector Management, would be used as a point of reference and comparison.³

For the purposes of the inquiry, services contracted included activities performed by private, public and not-for-profit contractors and in-house teams where they were competitively tendered.

The project related specifically to contracts for services valued at \$50 000 or more and did not include capital works and construction projects, or the purchase of goods.⁴ In order to report as accurately as possible on the extent of contracting, agencies were also asked to provide information on small multiple contracts within a particular service category which collectively exceeded the \$50 000 limit. Also, where multiple contracts existed for any service category, and it was not possible to separate single contract details, agencies were encouraged to supply aggregated data.

D.2 Survey methodology

D.2.1 Survey response

The survey was sent to 126 Commonwealth budget-funded agencies in April 1995. GTEs were not included in the project. Fifty-six responses were received, including eight nil returns from small agencies with no contracting activity above the \$50 000 limit. Due to the size, diversity and complexity of the data collection process and the decentralised nature of purchasing, a number of agencies stated that they were unable to collect the necessary information and could not participate in the project.

³ Sources:
Domberger, S., Farago, S., Hall, C., & Li, E. (1993)
Farago, S. & Domberger, S. (1994)
Farago, S., Domberger, S., Hall, C. & Li, E. (1994)
Farago, S, Hall, C. & Domberger, S (1994)
Domberger, S. and Skinner, V. (1995)
Victorian Government, Sub. 215

⁴ A number of other services were also excluded including Australia Post and Telecom services, scheduled airline services and rental of buildings or equipment.

Ten agencies were selected for intensive follow-up. They were the departments of Administrative Services (DAS); Social Security (DSS); Employment, Education and Training (DEET); Defence; Veterans' Affairs; Human Services and Health; the Australian Taxation Office; the Australian Bureau of Statistics (ABS); the Australian Customs Service and AusAID.

Of these agencies, six provided completed returns. The Department of Defence submitted a completed return only for CSP contracts and these have been included in the survey results. The departments of Human Services and Health and Defence (excluding CSP), and AusAID were unable to undertake the detailed data collection on the scale required by the survey but used existing central information systems to provide details of the extent of their contracting activity. This supplementary information has been detailed in attachment C but has not been included in the survey results as the data provided was not comparable.⁵ Further information on a range of issues was also provided by many agencies in their submissions to the inquiry.

In total, 43 agency returns were included in the survey results. However, not all agencies could provide information for every question and the sample size varied accordingly.

D.2.2 Statistical analysis

Entry of the raw data was carried out using a custom-designed Microsoft Access database. Microsoft Excel Version 5 and SPSS for Windows Version 6.1 were used for statistical analysis. The results were divided into four sections. A description of the survey content and the methodology used to analyse each section follows. The results are reported in section D.3.

Extent and scope of contracting

Agencies were asked to report on existing contracts and those let since 1 July 1994 which may have expired. Details were requested of: service type; contract numbers; the type of contractor; whether an in-house bid was submitted; what contractor selection method was used; whether the contractor was in-house or external; whether there was a formal redesign of the activity prior to it going to

⁵ For example, it was not possible to calculate the annual contract fee for the Department of Defence and AusAID contracts from the information available. Their databases contained details of the total contract value but without details of the contract term which could range from one month to ten years, it was not possible to convert this to an annual fee.

tender; the year the service was first contracted; and the commencement and expiry date of the contract.

Respondents were also asked to provide financial information on annual contract fees, contract management costs and the estimated cost of the service prior to contracting, including management costs. The survey is the first of its kind to separately identify all three factors. Only a small number of respondents were able to supply information on all three questions but a larger number were able to provide information on at least two of the three, ie either annual contract fee and prior costs or annual contract fee and management costs.

Savings and management costs were calculated from the sub-samples derived from these groups. The average overall net saving was based upon the total estimated annual cost prior to contracting, less the corresponding total of the combined cost of annual contract fees and estimated contract management costs per annum. This was expressed as a percentage of the estimated total annual cost prior to contracting. The average overall gross saving was based upon the total estimated annual cost prior to contracting less the annual contract fee. Again, this was expressed as a percentage of the estimated total annual cost prior to contracting.

It is important to note that the sample size differed significantly for many of the results. Section D2.3 outlines the sample selection process used to determine the main sub-samples. Yet even within each sub-sample there were variations according to whether agencies were able to provide all the relevant information. For example, the average contract length was calculated only from contract cases which reported both starting and finishing dates.

Assessment of the reasons for and outcomes of contracting

To provide an indication of the motivation for and performance of contracts, agencies were asked to rate the reasons for contracting and outcomes achieved and also provide an assessment of the quality of the service compared with expectations.

A four point rating system was used in the survey. While the subjective measure of quality is an ever-present problem in survey design, a four point scale was used to avoid a neutral bias, whereby respondents choose the middle value in a scale if they do not want to give a strong opinion. A four point scale avoids this effect and forces the respondent to give a definite answer. The alternative is to use the more conventional five point scale. This may increase accuracy but it is only negligible for a five point scale compared to a four point scale. A four point scale was also used to generate comparable results with similar surveys.

Correlation analysis was used to test whether there was a relationship between the stated reasons for contracting and the assessment of outcomes achieved, ie if the reason for the contract was rated as 'important', how often did the corresponding outcome rate 'successful', or not? The correlation coefficients measured the degree of correlation between the percentage of contracts for which reasons were rated as 'important' and the percentage of contracts for which the outcome was rated as 'successful'. SPSS was used to calculate the Spearman Rank correlation analysis. This method of analysis was chosen due to the ordinal nature of the data.

Agency approach to contracting

Each agency was asked to identify core and non-core services. This information was correlated with the survey results in order to assess whether contracting was restricted to non-core or support services. In addition, the extent of agency expenditure on contracted services was to be investigated by comparing information on an agency's annual recurrent expenditure and the survey results.

Section D.4 reports the results of comparisons with other jurisdictions. Some comparable data was available for similar surveys conducted in 1993 and 1994 for New South Wales, 1994 and 1995 for Western Australia and 1995 for Victoria. While it was inappropriate to compare agency functions for the States and the Commonwealth due to their differing activities and responsibilities, a comparison of service activities and trends in contracting was considered valuable. An overview of these comparisons is provided in section D.4. It should be noted that comparisons were limited because of differences in survey design, coverage and methodology.

D.2.3 Sample selection

Since the survey data consisted of both single and aggregated contracts, it was necessary to separate the data into a number of sub-samples.

The primary sample included all contract cases, ie both aggregate contract cases (contract cases reporting multiple contracts), and single contract cases. A contract case refers to each contracting instance listed in the survey returns and differs from contract numbers. There were 1751 contract cases for 51 842 contracts with a combined value of \$1 853 758 639.

Eighty-seven per cent of all contract cases were for single contracts only. These formed the secondary sample. Its sample size was 1515 contracts, worth \$776 648 163.

Sensitivity tests revealed significant differences between the primary and secondary samples. The number and combined value of the aggregated contract cases dominated the primary sample even though single contracts were a larger proportion of the returns.

It was therefore appropriate to use the primary sample only to illustrate the extent of contracting without conducting micro analysis on tendering processes and outcomes, or financial analysis. Only the secondary sample, which provided more reliable data on individual contracts, was used for micro analysis.

Financial analysis was based on the response to three questions which sought information on the annual contract fee, management costs per annum and annual costs of providing the service prior to contracting. As not all agencies were able to provide information on all three, it was necessary to divide the secondary sample into three sub-samples where information was provided on at least two of the three questions.

The management sample included all single contract cases with data on the annual contract fee and estimated management costs per annum. This sub-sample was 609 contracts and was worth \$237 371 195.

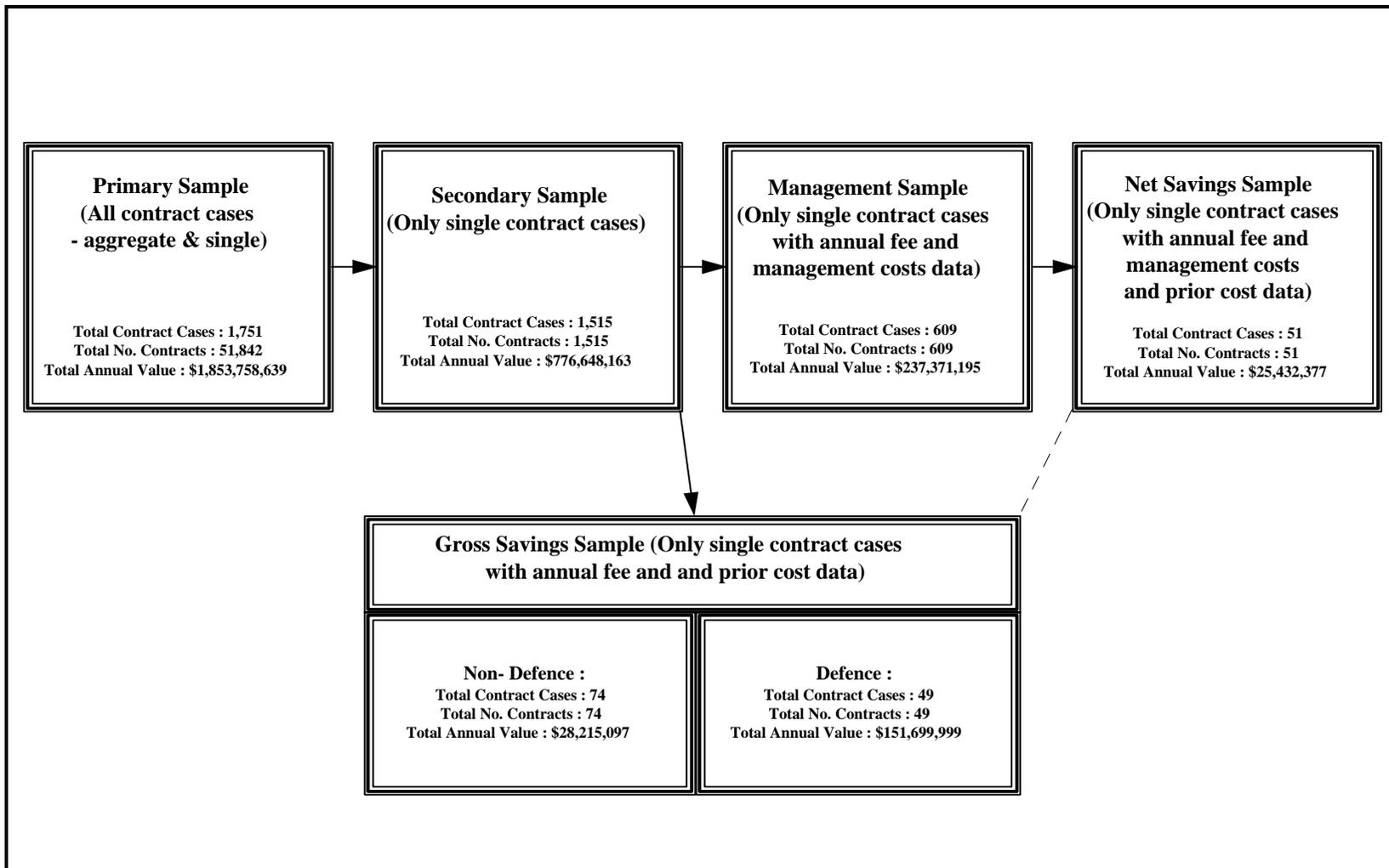
The net savings sample was drawn from the management sample, which in turn was drawn from the secondary sample. The savings sample included all single contract cases with data on the annual contract fee, estimated management costs per annum and estimated annual cost prior to contracting. The sample size was 51 contracts, 3.37 per cent of the secondary sample and was worth \$25 432 377.

The remaining contract cases with data on annual contract fee and prior costs but not management costs were used to calculate gross savings. The methodology used was comparable to previous surveys in New South Wales for agencies which did not specifically identify management costs. This sample was also drawn from the secondary sample and contained 123 contract cases including 49 Defence CSP contracts worth \$151 699 999. It was then split into two groups as sensitivity analysis showed that the number and size of Defence CSP contracts skewed the results.

The non-Defence sample contained 74 contract cases with a combined value of \$28 215 097. It included all the net savings sample contracts and a further 23 non-Defence contract cases. The Defence CSP and non-Defence gross savings samples were 3.23 and 4.88 per cent of the secondary sample respectively.

Figure D.1 outlines the process of sample selection.

Figure D.1: Survey Samples



D.3 Results

D.3.1 Extent and scope of contracting

The primary sample was used to provide an indication of the extent of contracting. It contained 1751 contract cases for 51 842 contracts with a combined value of \$1 853 758 639. However, 42 657 of these contracts consisted of contract health care providers for the operations of the Department of Veterans' Affairs.⁶ These contracts had a combined total value of \$381 409 000 in 1994-95.

The agencies with the highest value of contracted services in 1994-95 were Veterans' Affairs (\$824 512 048); DEET (\$302 819 094); Defence CSP (\$161 999 999); DAS (\$151 363 798) and DSS (\$134 364 177). The 20 agencies with the highest value of contracts are shown in table D.1.

⁶ Health Care Providers are located Australia-wide and, with one or two minor exceptions, do not have written contracts. This situation is being rectified through the gradual implementation of a written contract with all providers. Health care providers are in the fields of podiatry, dentistry, dietary care, optometry, physiotherapy and hospital services (public and private).

Table D.1: Top 20 contracting agencies surveyed by value in 1993–94

<i>Agency Rank</i>	<i>Agency Name</i>	<i>Annual Fee Agency Total</i>
1	Dept. of Veterans' Affairs	\$824 512 048
2	Dept. of Employment, Education & Training	\$302 819 094
3	Defence CSP	\$161 999 999 ^a
4	Dept. of Administrative Services	\$151 363 798
5	Dept. of Social Security	\$134 364 177
6	Dept. of Transport	\$52 767 788
7	Australian Customs Service	\$43 396 809
8	Aust. Hearing Services Authority	\$32 375 000
9	Dept. of Primary Industries & Energy	\$22 558 807
10	Attorney-General's Department	\$21 747 875
11	Commonwealth Bureau of Meteorology	\$12 731 311
12	Dept. of Communication & the Arts	\$9 091 563
13	COMSUPER	\$8 485 428
14	National Capital Planning Authority	\$8 285 080
15	Aust. National Audit Office	\$8 185 441
16	Aust. Bureau of Statistics	\$6 935 200
17	Dept. of Prime Minister & Cabinet	\$6 688 050
18	Special Broadcasting Service	\$6 225 289
19	Family Court of Australia	\$4 926 000
20	Aust. Industrial Registry	\$4 355 000

a Includes only CSP contracts supplied by Department of Defence.

Table D.2 provides information on the agencies with the highest number of contracts. Contract numbers were enhanced by the number of multiple contracts for services such as program services and contract staff. For example, the Australian Film and Television School had 1800 contracts for external training providers, while the Department of Veterans' Affairs had 42 657 contacts with health-care providers. These groups of employees were classified as contract staff. Program services were seen mainly in DEET for labour market and job training programs such as LEAP and Jobskills.

Table D.2: Top 20 contracting agencies surveyed by contract numbers

<i>Agency Rank</i>	<i>Agency Name</i>	<i>No. of Contracts Agency Total</i>
1	Dept. of Veterans' Affairs	44 295 ^a
2	Aust. Film, Television & Radio School	1 902 ^b
3	Dept. of Administrative Services	1 387 ^c
4	Dept. of Employment, Education & Training	1 183 ^d
5	Dept. of Social Security	787
6	Commonwealth Bureau of Meteorology	588
7	Aust. Bureau of Statistics	312
8	Special Broadcasting Service	257
9	Australian Customs Service	136
10	Aust. Hearing Services Authority	129
11	Dept. of Primary Industries & Energy	115
12	Dept. of Finance	108
13	Dept. of Transport	88
14	Attorney-General's Department	72
15	Dept. of Communication & the Arts	55
16	Defence CSP	54
17	COMSUPER	49
18	National Capital Planning Authority	44
19	Industry Commission	32
20	Aust. National Audit Office	31

a Includes 42 657 contracts for health-care providers.

b Includes 1 800 contracts for external training providers.

c Includes a large number of aggregated contracts for services such as cleaning, security and removals.

d Includes a large number of aggregated contracts for training providers.

From the primary sample, contracts were let across 35 service categories. In terms of contract value in 1994-95, services with the highest value of contracting expenditure were contract staff (\$804 million), program services (\$193 million), information technology (\$172 million), training, development and education (\$119 million), and transport management and services (\$109 million). There were 1751 contract cases for 51 842 contracts with a value of \$1 853 758 639. The average annual contract fee from this sample was calculated to be \$35 757.85. Table D.3 lists the top 20 services by annual value.

Table D.3: Top 20 contracted services surveyed by value

<i>Rank</i>	<i>Service Categories</i>	<i>Annual Value</i>
1	Contract staff	\$803 665 104
2	Program services	\$192 710 374
3	Information technology	\$172 098 447
4	Training, development and education	\$119 432 407
5	Transport management and services	\$109 298 638
6	Research, scientific and technical services	\$75 617 046
7	Facilities management	\$37 248 745
8	Financial management	\$35 470 932
9	Cleaning	\$32 100 827
10	Printing and publication services	\$29 333 663
11	Management services (not elsewhere classified)	\$28 775 018
12	Property management and services	\$26 968 849
13	Executive management services	\$25 314 809
14	Security	\$22 001 591
15	Legal services	\$12 662 228
16	External relations	\$12 163 321
17	Medical services	\$11 037 470
18	Audio visual services	\$7 398 589
19	Human resources	\$5 037 000
20	Administrative support	\$2 791 499

The greatest number of contracts were recorded for contract staff (44 009), training, development and education (2 424), cleaning (1 058), research, scientific and technical services (781) and printing and publication services (741). The top 20 services by contract numbers are shown in table D.4.

Table D.4: Top 20 contracted services surveyed by contract numbers

<i>Rank</i>	<i>Service Categories</i>	<i>No. of Contracts</i>
1	Contract staff	44 009
2	Training, development and education	2 424
3	Cleaning	1 058
4	Research, scientific and technical services	781
5	Printing and publication services	741
6	Information technology	697
7	Program services	375
8	Transport management and services	353
9	Audio visual services	263
10	Human resources	186
11	Security	182
12	Administrative support	119
13	Financial management	101
14	Executive management services	69
15	External relations	69
16	Facilities management	64
17	Property management and services	62
18	Management services (not elsewhere classified)	46
19	Medical services	44
20	Legal services	36

Table D.5 shows the services contracted by the most agencies. Information technology heads the list with 26 agencies choosing to contract it, followed by research, scientific and technical services (24), security (20), financial management (20) and then cleaning (18).

Table D.5: Top 20 services surveyed by number of agencies

<i>Service Categories</i>	<i>Agency Count</i>
Information technology	26
Research, scientific and technical services	24
Security	20
Financial management	20
Cleaning	18
Property management and services	17
External relations	15
Executive management services	15
Printing and publication services	14
Facilities management	14
Transport management and services	12
Training, development and education	12
Management services not elsewhere classified	12
Legal services	10
Administrative support	9
Information management	8
Contract staff	8
Audio visual services	8
Program services	7
Project management	6

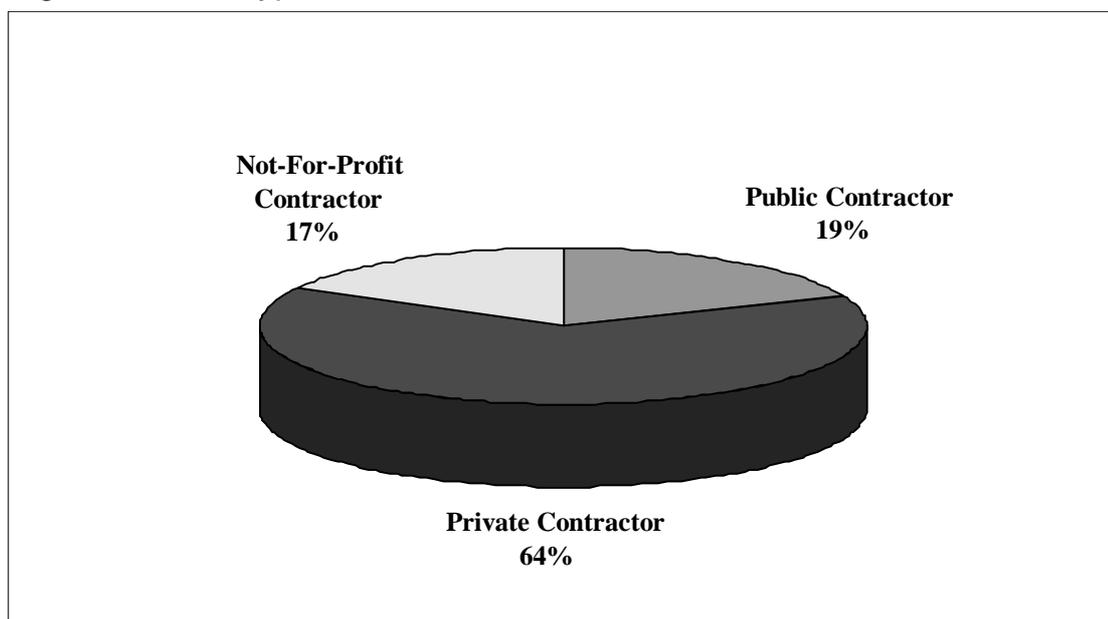
Micro analysis of contracts

The following results are based on the secondary sample, that is, for single contracts only.

Of the type of contractor used, the predominant choice was a private contractor with 64 per cent or 976 contract cases. Public contractors, including government agencies or GTEs, were the second most popular with 19 per cent (282 contract cases). DAS, in particular, was nominated as a public contractor for the supply of inter-agency services. Not-for-profit contractors such as local associations, community groups, and universities, were selected for the remaining 17 per cent (257 contracts).⁷ Figure D.2 shows the breakdown.

⁷ Not-for-profit can be defined as an organisation which is exempt from corporate income taxes, is legally prohibited from distributing profits to its owners, and may accept contributions that invite tax exemptions for donors. Industries such as the arts, hospitals and higher education are characterised by the presence of both profit and non-profit firms.

Figure D.2: Type of contractor



Tables D.6 and D.7 relate to in-house bidding. Table D.6 shows the number of such bids submitted, table D.7 their success rate. Only 10.2 per cent of contract cases included bids by 'in-house' contractors. These represented just 154 contracts. Agencies which prepared in-house bids included the Department of Defence, DEET and DAS.

Most agencies had few or no in-house bids and contracts. As the Department of Transport (DoT) explained:

As a general rule, DoT relies on its own staff to perform its functions except to meet unforeseen workloads or where specialist skills or facilities not available within the department are required. As a consequence, we do not undertake 'internal bidding' for specific tasks.

Table D.6: In-house bids submitted

<i>Title</i>	<i>Contract Nos.</i>	<i>Per cent</i>
In-house bid was submitted	154	10.2%
In-house bid was not submitted	1 361	89.8%
Total	1 515	100%

In total there were 23 contracts from this sample which were awarded in-house, indicating that 15 per cent of in-house bids were successful.

Table D.7: In-house or external contractor

<i>Title</i>	<i>Contract Nos.</i>	<i>Per cent</i>
In-house contractor	23	1.5%
External contractor	1 492	98.5%
Total	1 515	100%

Figure D.3 illustrates that public tenders were the preferred method for selecting a contractor for 570 cases or more than one third of the sample. Inviting several firms to bid was the next most popular method with 399 cases, or 26 per cent. Sixteen per cent of agencies nominated ‘Other’ as the selection method followed by 11 per cent who invited single firms to bid, and 9 per cent who extended existing contracts.

Figure D.3: Contractor selection method

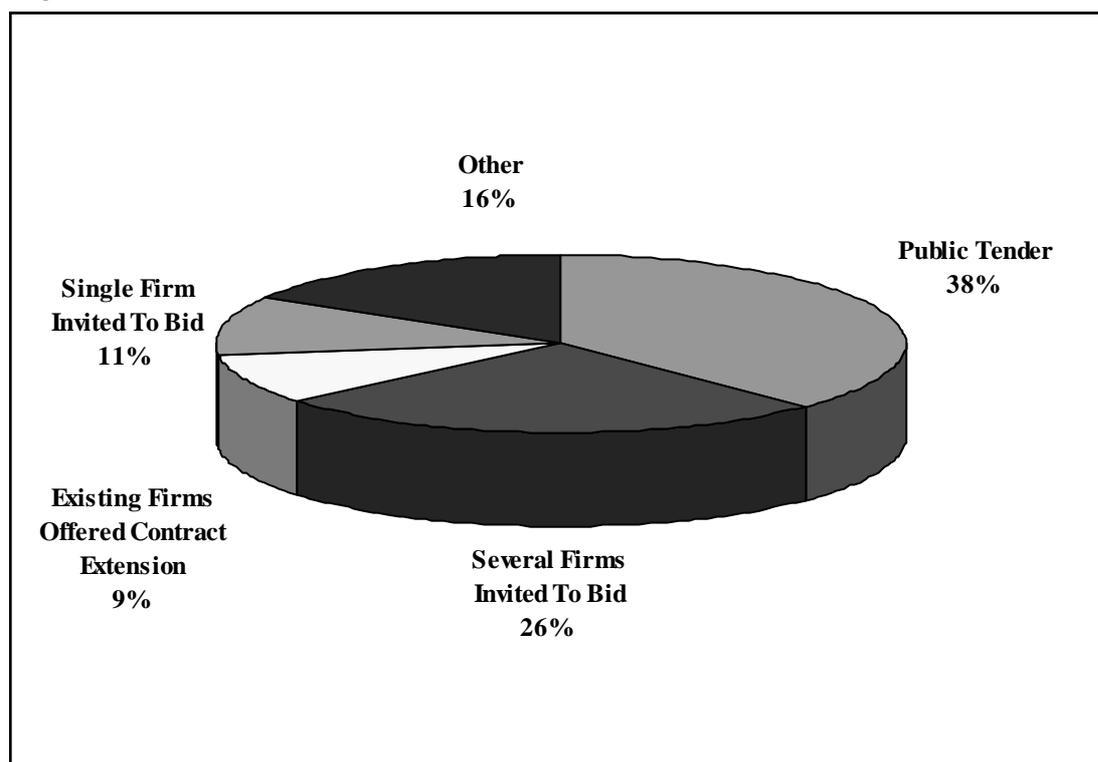


Table D.8 illustrates the number of contracts which underwent some sort of formal redesign of the specifications prior to being tendered. This occurred for 271 contracts representing 17.9 per cent of the secondary sample.

Table D.8: Service redesign prior to tendering

Title	Contract Nos.	Per cent
Formal redesign	271	17.9%
No formal redesign	1 244	82.1%
Total	1 515	100%

The length of contracts varied greatly, from short term periods to those extending over a period of ten years. As not all agencies were able to supply start and expiry dates, the total number of cases used to calculate the average contract length was 70 per cent of the secondary sample. The average length of contract for this sample was approximately 548 days, or 1.5 years.

Figure D.4 shows the average contract length for each service category. Hospitality and catering contracts had the longest contract term followed by building maintenance, storage, travel arrangements, transport management and services, miscellaneous services, mail and courier services and waste management. A significant number of services had short term contracts of less than one year.

Figure D.4: Average length of service contracts in years

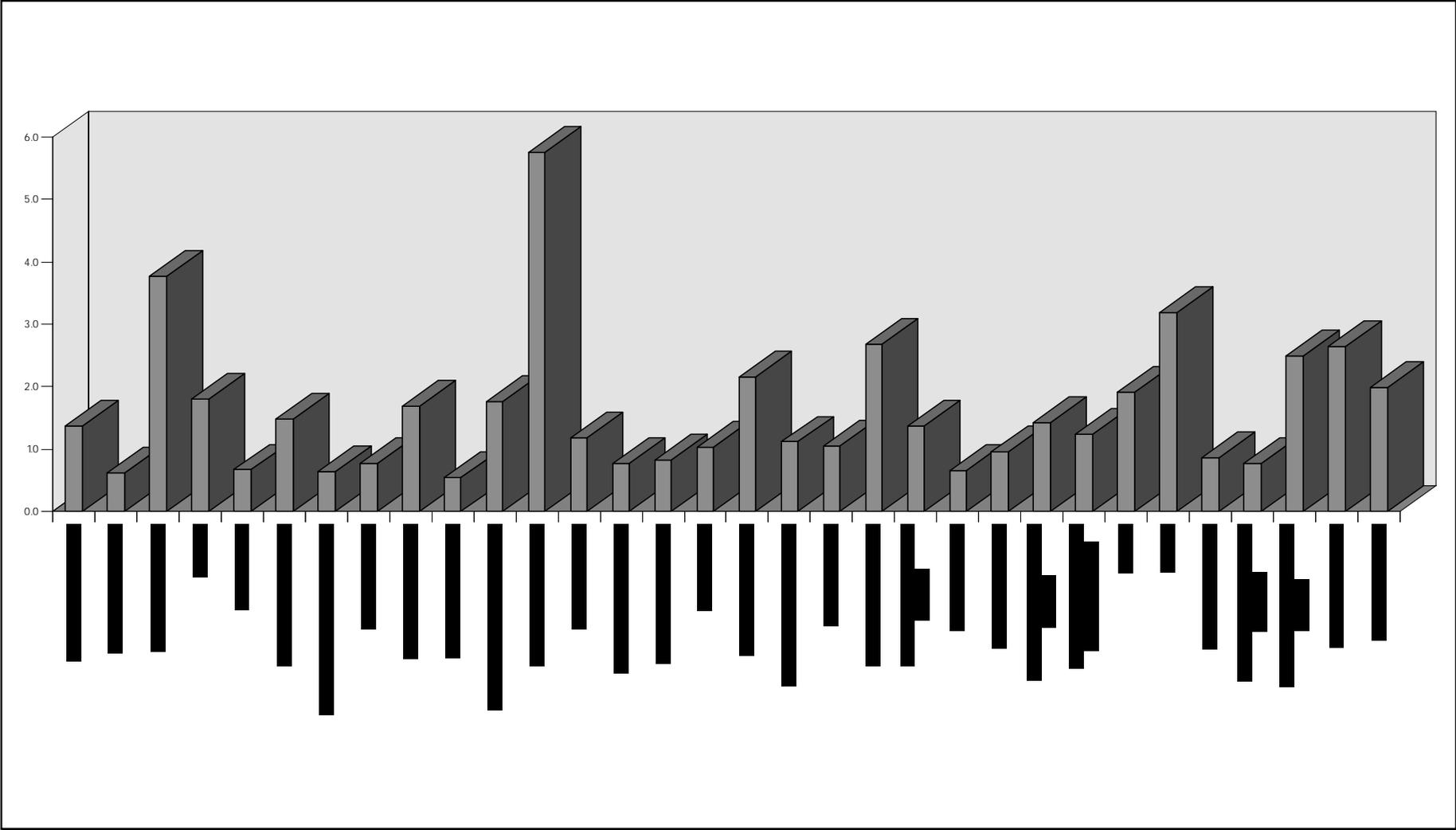
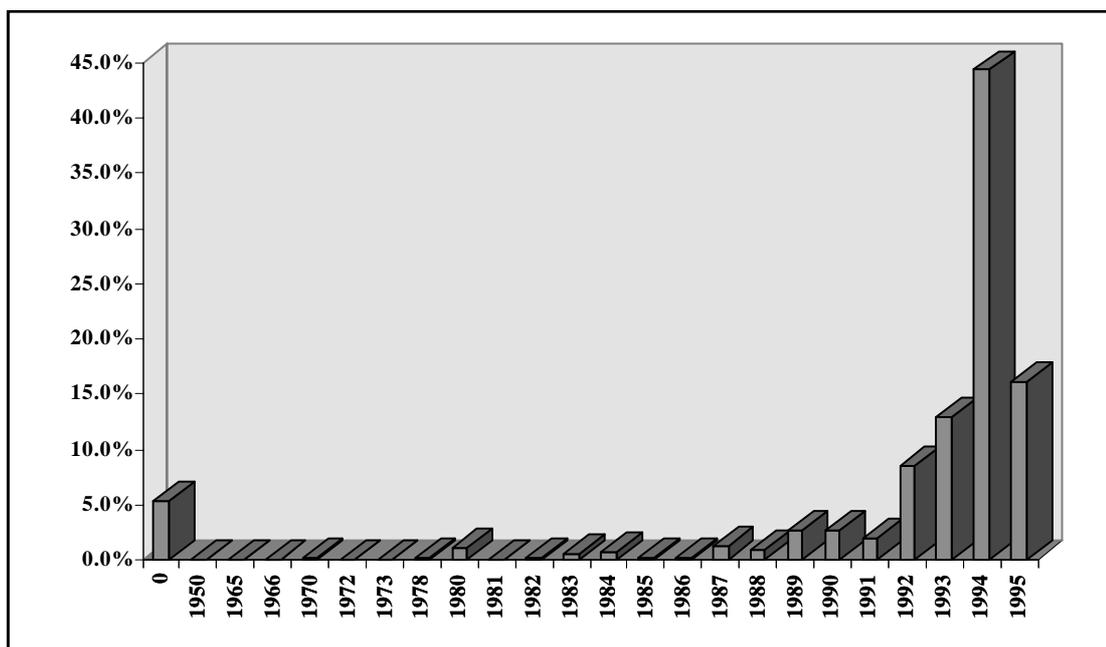


Figure D.5: Services contracted for the first time



Agencies were asked to indicate the year in which each service was contracted for the first time. This varied significantly. Some services in the sample were first contracted in the 1950s and 1960s, with the earliest being a contract for marine communication in 1950. As clearly demonstrated in figure D.5 there has recently been a sharp increase in the number of first time contracts. The most common year was 1994, with 44.4 per cent of services being contracted for the first time. It was followed by 16.1 per cent in 1995, even though at the time the survey was undertaken, a full year had not expired. Approximately 5 per cent of agencies were unable to supply an answer to this question.

Tables D.9, D.10 and D.11 provide details of the financial analysis. The average net saving shown in table D.9 was calculated from the totals of annual contract fees, management costs and prior costs for 51 contracts covering 22 services. Net savings, on average, were 16.3 per cent.

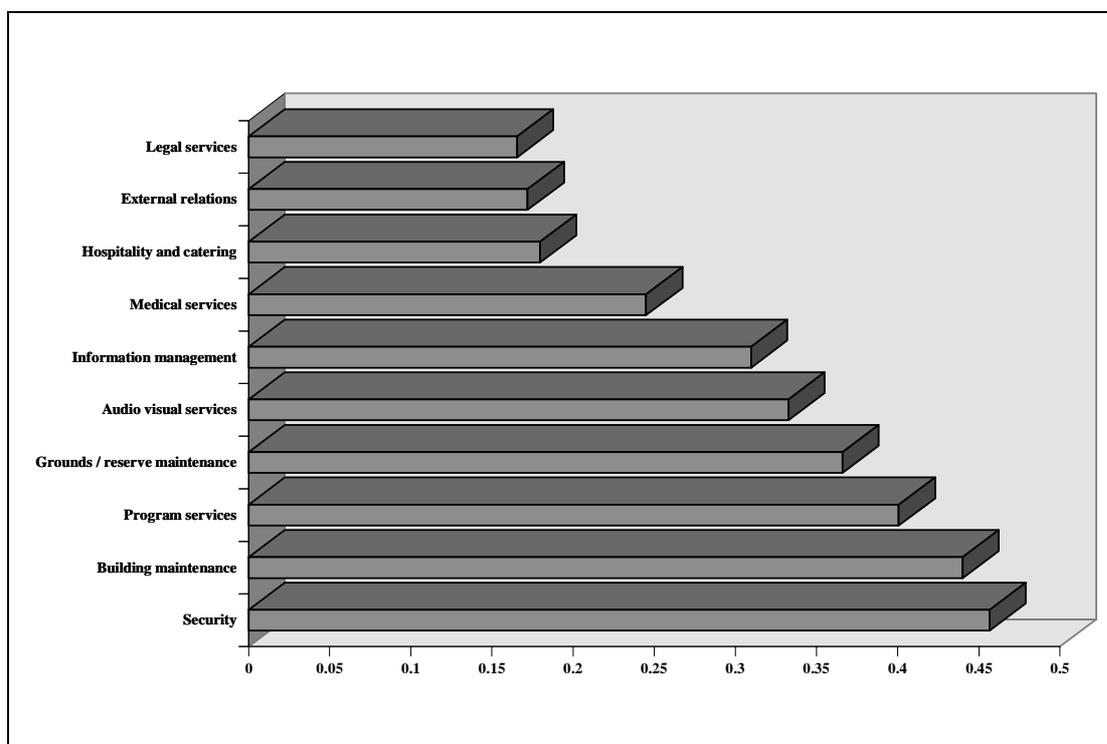
Table D.9: Net savings*

Total annual fee:	\$25 432 377.00	
Total management costs:	\$402 675.00	
Total prior cost:	\$30 869 088.00	
Total savings:	\$5 034 036.00	
Average prior cost:	\$605 276.24	
Average annual fee:	\$498 674.06	
Average management costs:	\$7 895.59	
Average savings per contract:	\$98 706.59	
Average savings per cent:	16.3%	
Total Contract Cases:	51	3.3% of Secondary Sample

* Using those contracts with annual fee, management costs and prior costs

Examples of the average net savings achieved on a service basis are shown in figure D.6. It should be noted that the service categories showing the highest percentage savings, security and building maintenance, are also services where contracting is commonplace. The third largest savings was reported by program services, a significant number of which were the DEET labour market program.

Figure D.6: Top ten average savings by service category



A number of services did record a rise in expenditure following contracting. These include executive management services (-21 per cent), property management services (-7.3 per cent), travel services (-6.8 per cent) and research, scientific and technical services (-2 per cent).

Gross savings were generated by analysing a further 123 cases, 8.1 per cent of the secondary sample, for agencies which were able to supply information on annual contract fees and prior contract costs but not management costs. The results are reported in table D.10, which shows all non-Defence CSP contracts and table D.11, which shows Defence CSP contracts.

The non-Defence group was based on a sample of 74 contracts with an average contract value of \$381 285. The average gross saving was 18.1 per cent.

Table D.10: Gross savings excluding Defence CSP*

Total annual fee:	\$28 215 097	
Total prior cost:	\$34 453 140	
Total savings:	\$6 238 043	
Average prior cost:	\$465 583	
Average annual fee:	\$381 285	
Average savings per contract:	\$84 298	
Average savings per cent:	18.1%	
Total Contract Cases:	74	4.9% of Secondary Sample

* Using those contracts with annual fee and prior costs

The Defence CSP sample includes 49 contracts worth \$151 699 999 with an average contract value of \$3 095 918. The average gross savings were 35.7 per cent.⁸

⁸ Please note that the sample used to calculate this result varies slightly from that used to calculate the 33 per cent figure reported in the *CSP Update*, Issue No. 20, Nov. 1994, p.4. The two results show a small 2 per cent difference in outcome.

Table D.11: Gross savings Defence CSP*

Total annual fee:	\$151 699 999	
Total prior cost:	\$236 099 999	
Total savings:	\$84 400 000	
Average prior cost:	\$4 818 367	
Average annual fee:	\$3 095 918	
Average savings per contract:	\$1 722 449	
Average savings per cent:	35.7%	
Total Contract Cases :	49	3.2% of Secondary Sample

* Using those contracts with annual fee and prior costs

A large number of agencies, 39.3 per cent of the secondary sample, were able to provide information on current contract and management costs. This is reported in table D.12. The sample comprised 609 contracts worth \$237 371 195, with an average contract value of \$389 772. The average management cost for a contract of this size was \$9058, or 2.32 per cent of the contract value, which is comparable to the 1.8 per cent difference between net and gross savings.

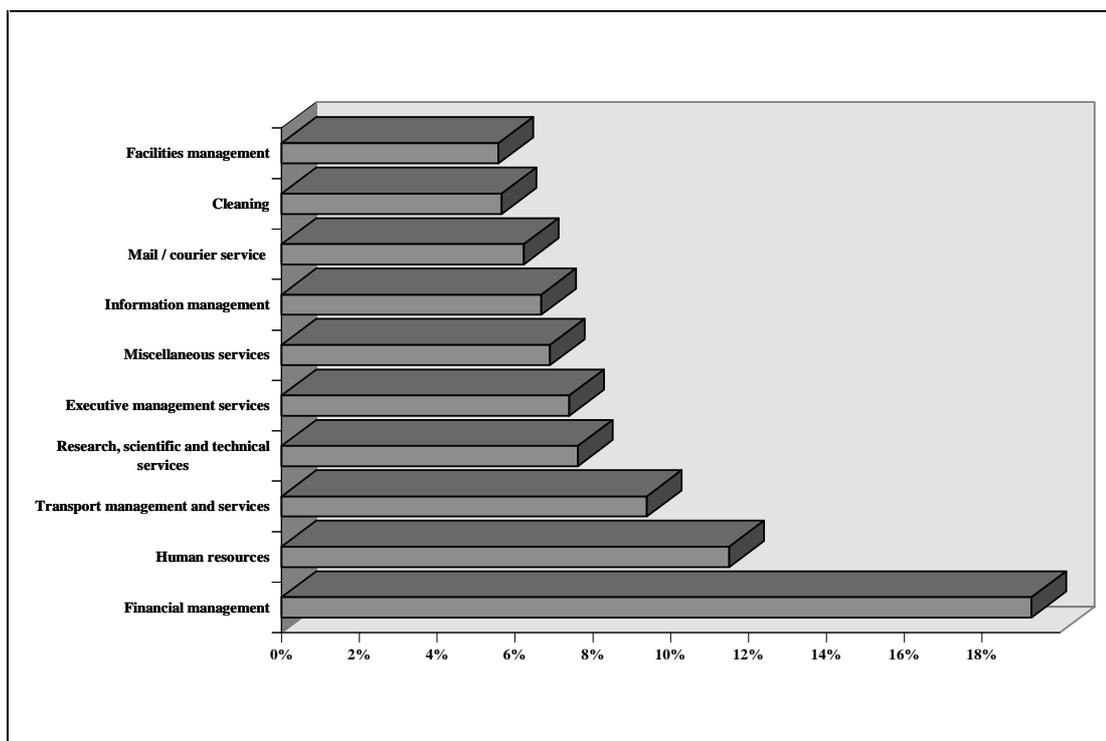
Table D.12: Management costs*

Total annual fee :	\$237 371 195.00	
Total management costs :	\$5 516 728.00	
Average contract fee :	\$389 772.08	
Average management costs :	\$9 058.67	
Average management per cent	2.32%	
Total Contract Cases:	609	40.2% of Secondary Sample

* Using those contracts with annual fee and management costs

Average management costs were calculated for each of the service categories represented in the sample. Figure D.7 shows which service categories are the most expensive in terms of management costs. The lowest average management costs were reported by hospitality and catering services (0.33 per cent) legal services (0.55 per cent), contract staff (0.67 per cent), management services (not elsewhere classified) (0.68 per cent) and medical services (0.75 per cent). Thirty-three service categories contained information on management costs but it should be noted that the sample size for many was small.

Figure D.7: Service categories with the highest management costs



D.3.2 Assessment of the reasons for and outcomes of contracting

To indicate their motivation for contracting, respondents were asked to rate reasons according to the following scale: 1 = Very Important, 2 = Important, 3 = Relevant (but not essential) and 4 = Least important. The reasons listed were: efficiency (cost reductions), effectiveness (to ensure service delivery) and other (to state as appropriate). The same rating could be given to more than one reason.

The single most highly rated reason for contracting was effectiveness. This rated as 'very important' for 543 cases whereas efficiency rated as 'very important' for 312 cases. 'Other' reasons also scored highly, with 772 cases rated as 'very important'. The type of reasons given for 'other' included 'government directive', 'lack of expertise', 'resource constraints' and 'budget directive'. Figures D.8, D.9 and D.10 provide a more detailed breakdown of the ratings for efficiency, effectiveness and 'other'.

A total of 1059 responses were received on the question of rating efficiency. It was rated as 'very important' in 29 per cent of cases, and 'important' in 31 per

cent. Only 4 per cent of cases rated efficiency as 'least important'. The remaining 36 per cent rated efficiency as 'relevant (but not essential)'.

Figure D.8: Efficiency

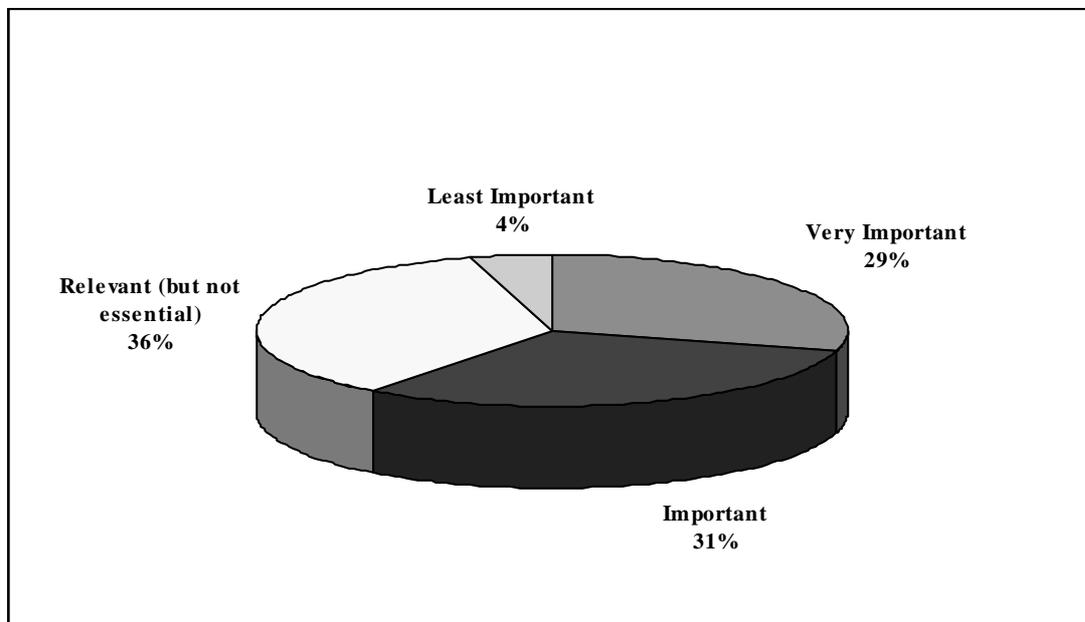


Figure D.9 illustrates the corresponding response for effectiveness. It rated as 'very important' in 48 per cent of cases and 'important' in 48 per cent. This was a very high rating for effectiveness, revealing its importance as a reason for contracting. Only 1 per cent of cases rated effectiveness as 'least important' and the remaining 3 per cent rated effectiveness as 'relevant (but not essential)'. There were 1 140 responses to this question.

Figure D.9: Effectiveness

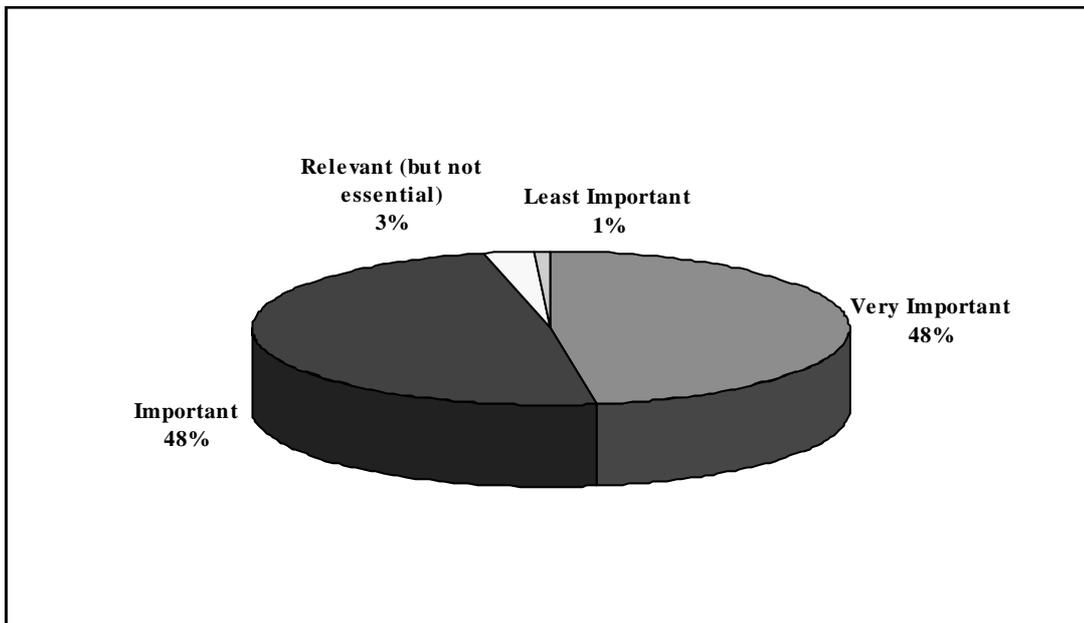
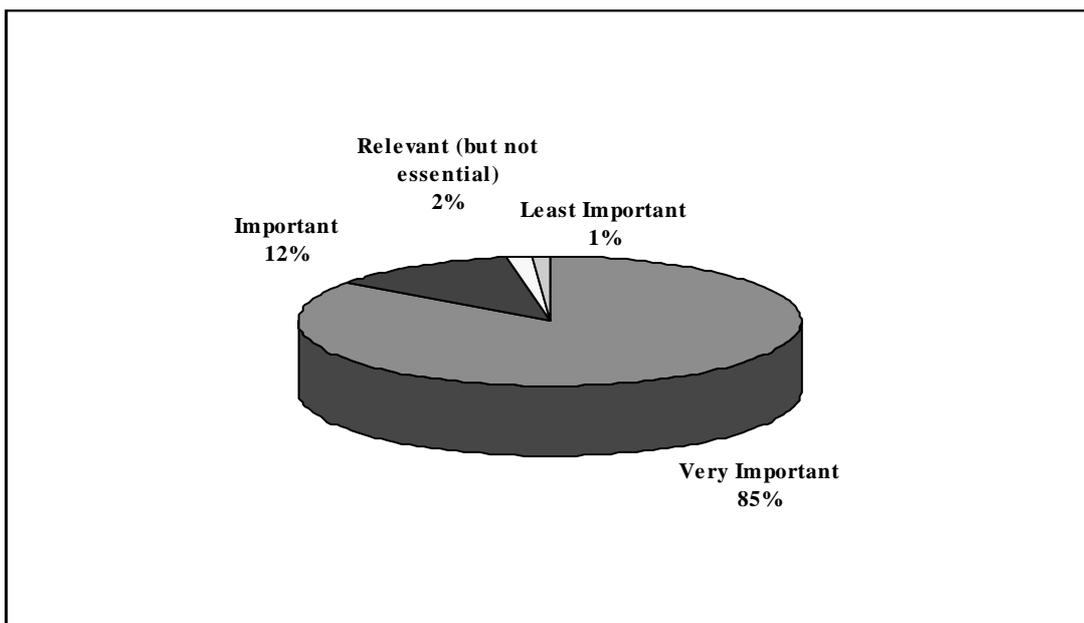


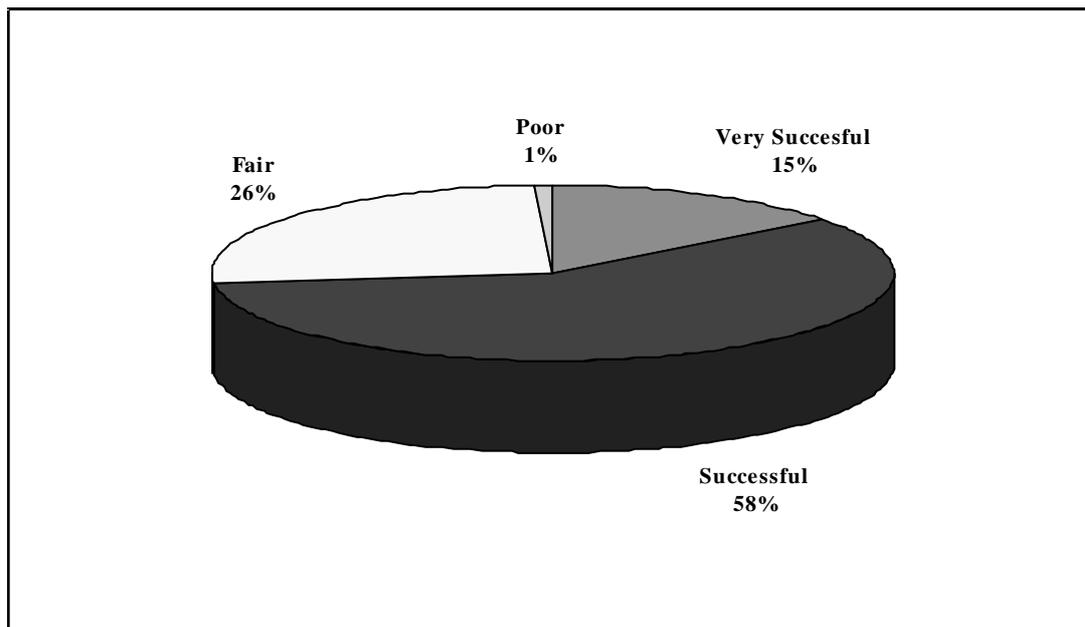
Figure D.10 shows ‘other’ was ‘very important’ in 85 per cent of cases, while ‘important’ rated only 12 per cent. Less than 1 per cent (0.7) of cases rated ‘other’ as ‘least important’. The remaining 2 per cent rated efficiency as ‘relevant (but not essential)’. There were fewer responses to this question; 908 responses compared to 1059 responses for efficiency and 1140 responses for effectiveness.

Figure D.10: Other



Agencies were asked to rate the outcome achieved, where: 1 = Very Successful, 2 = Successful, 3 = Fair, and 4 = Poor. Comparatively few contract cases, 15 per cent, were rated as 'very successful'. The majority, 673, or 58 per cent were rated as 'successful'. Only 1 per cent of cases were rated as 'poor'. There were 1 150 responses to this question (see figure D.11).

Figure D.11: Contracting outcomes

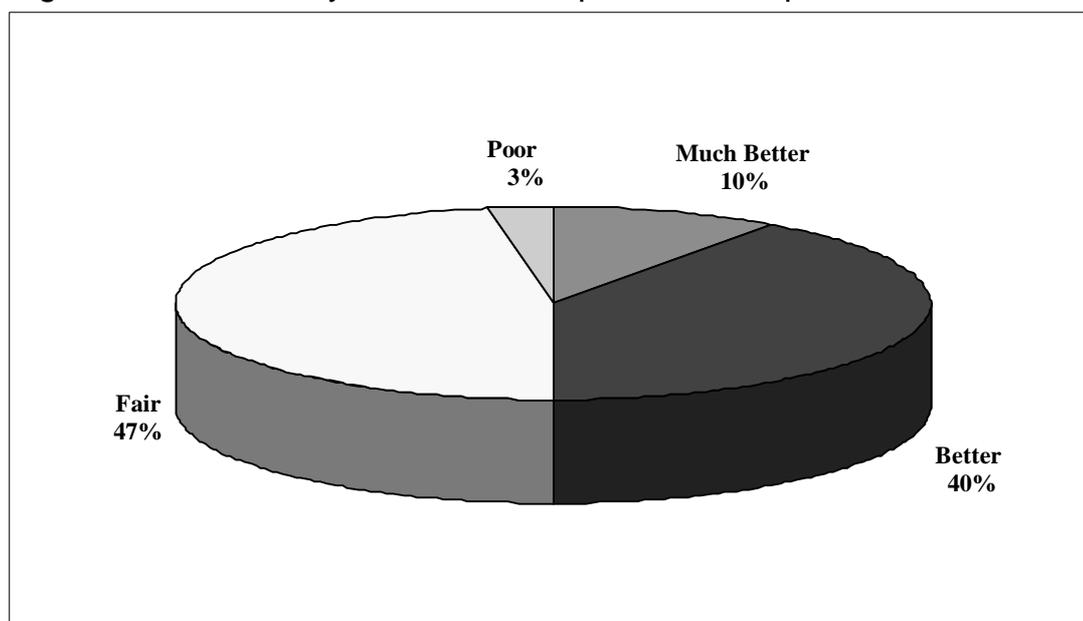


Spearman Rank correlation analysis found that the relationship between the level of importance placed on effectiveness as a reason for contracting and the rating of the success of the contract was positive ($r = 38$ per cent), with a high level of significance. Similar results were obtained for the relationship between the level of importance placed on efficiency as a reason for contracting and the rating of the success of the contract ($r = 36$ per cent), with a high level of significance. Correlation analysis on the relationship between the level of importance placed on 'other' as a reason for contracting and the rating of the success of the contract was positive ($r = 26$ per cent), with a high level of significance.

The impact of contracting on service quality was investigated by asking agencies to rate the quality of service compared with expectations. Answers were provided on the following scale: 1 = Much Better, 2 = Better, 3 = Fair and 4 = Poorer. Responses are shown in figure D.12.

There were 994 answers to this question. Of these, 10 per cent rated the quality of service compared with expectations as 'much better', and a further 40 per cent rated the quality of service compared with expectations as 'better'. The largest rating was 'fair' which received 47 per cent. Only 3 per cent rated the quality of service compared with expectations as 'poor'.

Figure D.12: Quality of service compared with expectations



Information was also collected on contracts which had been terminated or not renewed for any reason since the start of the 1994-95 financial year. Agencies provided details of 34 such contracts. Fifty per cent of these were terminated due to unsatisfactory service. Other reasons included discontinuation of the service by the contractor or the service was no longer required.

D.3.3 Agency approach to contracting

The survey sought to obtain additional information which would assist in determining the extent of contracting for services within each agency and also show the extent to which core and non-core services were contracted. The results of this part of the survey are only briefly considered in this report because of the paucity of useable information that was provided by agencies.

Further analysis will be necessary to establish the proportion of recurrent expenditure that is allocated to contracting for services by individual agencies. A significant percentage of many agencies' expenditure represents transfer payments, providing funding through grants or aid to other jurisdictions or

organisations. The proportion of agency expenditure on services is therefore heavily dependent on the nature of each agency's functions. The results of this aspect of the survey have not been reported here but may well provide baseline information for future research.

Agencies were asked to identify which services represented core or non-core activities for their organisation and the survey results were then used to identify whether these services were being contracted. Attachment D provides information based on the responses of two agencies, the Australian Industrial Registry and the Department of Primary Industries and Energy. They were chosen as examples of a large and a small agency. The tables show that both core and non-core services were contracted. Without further financial analysis of agency expenditure it is not possible to determine the extent to which this is occurring.

D.4 Comparisons with other jurisdictions

As mentioned previously, comparisons between jurisdictions have obvious limitations due to the varied nature of government activity and undertakings. This should be kept in mind when interpreting results. However, it is possible to provide some understanding of common approaches to contracting and differences where they occur.

This section provides a broad comparison between the Commonwealth survey and those of other jurisdictions, namely New South Wales, Western Australia and Victoria. Information has only been provided where comparable data is available. It should be noted that the surveys differed in terms of design, methodology and coverage. The main differences can be summarised as follows:

- the Western Australia survey was sent to budget-funded agencies and GTEs, the New South Wales survey included budget-funded agencies and ten GTEs while the Commonwealth survey results are based on a relatively small number of budget-funded agencies and exclude GTEs. It follows that the overall scope of contracting is likely to be understated for the Commonwealth;
- the New South Wales surveys excluded consultancy services;
- the Commonwealth survey was the only survey for which management costs were separately identified;
- classification of service categories differs slightly between jurisdictions. The classification tables have been developed over time. No suitable

classification of service categories exists although government accounting codes and NATO service classifications were used as reference points. The most notable difference between the Commonwealth and the States has been the inclusion of program services and a clear separation of contract staff. In previous surveys contract staff may have been spread among broader service classifications, for example, lawyers were classified under legal services and medical staff under medical services. Only contract staff (not elsewhere classified) were collected into a separate category. The number and size of contract staff reported by Commonwealth agencies clearly warranted such separation; and

- the same questions were not asked in all surveys. Only comparable data is reported or, where possible, adjustments have been made to overcome any methodological differences.

A comparison of the extent of contracting between the States and the Commonwealth is provided in table D.13. Information on the total value of single contracts over \$50 000 and the total value of aggregated contracts has been provided. Despite the small number of agencies surveyed, the Commonwealth had the highest combined value of single and aggregated contracts. The average value of single contracts was highest in New South Wales at \$588 807 compared to \$512 639 for the Commonwealth and \$341 394 for Western Australia.

Table D.13: Value of contracts

<i>Survey</i>	<i>No. of agencies</i>	<i>No. of single contracts >\$50 000</i>	<i>Total Value of single contracts</i>	<i>Average single contract value</i>	<i>Total no. of contracts</i>	<i>Total value of contracts</i>
WA 1994	106	487	\$166 259 002	\$341 394	89 102 ^a	\$365.4 million
NSW 1994	66	609	\$358 583 653	\$588 807	over 82 000 ^b	\$1.064 billion
Commonwealth 1995	43	1 515	\$776 648 163	\$512 639	51 842 ^c	\$1.853 billion

a includes 86 171 contracts let by the BMA, the Department of Planning and Urban Development and the Legal Aid Commission.

b includes 62 000 contracts let by the Legal Aid Commission.

c includes 42 657 contracts for Health Care Providers let by the Dept of Veterans' Affairs. Excludes GTEs and a large number of budget-funded agencies.

Information for New South Wales, Western Australia and Victoria was compiled to provide a comparison of the types of services most commonly contracted. Table D.14 lists the top 20 service categories by contract number

and table D.15 the top 20 by contract value. There is a significant overlap between all jurisdictions of the type of services contracted, but there are also some differences. For example, Western Australia is the only jurisdiction which includes forestry in the top 20 services contracted.

Table D.14: Top 20 service categories by contract number

<i>WA 1994</i>	<i>NSW 1994</i>	<i>Victoria 1995</i>	<i>Commonwealth 1995</i>
Building maintenance	Legal service	Information technology	Contract staff
Legal services	Contract staff not elsewhere classified	Technical services	Training, develop. and educ.
Property management	Transport services	Cleaning	Cleaning
Transport services	Building maintenance	Works related services	Research, scientific & technical
Cleaning	Training & education	Transportation services	Printing & publication services
Financial services	IT services	Financial services	Information technology
Technical services	Technical services	Building maintenance	Program services
Grounds maintenance	Printing & publishing	Administration	Transport mgt and services
Misc. services	Cleaning	Training	Audio visual services
Information technology	Equipment maintenance	Security	Human resources
Vehicle maintenance	Medical services	Printing	Security
Forestry services	Grounds/reserve maint.	Legal services	Administrative support
Printing	Administrative support	Human resource management	Financial management
Management services	Financial services	Marketing	Executive management services
Equipment maintenance	Hospitality & catering	Equipment maintenance	External relations
Works related services	External relations	Mail services	Facilities management
Security	Property management	Medical services	Property mgt & services
Legal & financial	Security	Facilities management	Management services not elsewhere classified
Investigative services	Waste management	Video/photography	Medical services
Media services	Visual & audio services	Telecommunications	Legal services

Table D.15: Top 20 services by value of contract

<i>WA 1994</i>	<i>NSW 1994</i>	<i>Victoria 1995</i>	<i>Commonwealth 1995</i>
Building maintenance	Building maintenance	Works related services	Contract staff
Forestry services	Transport services	Cleaning	Program services
Transport services	Contract staff not elsewhere classified	Building maintenance	Information technology
Information technology	Equipment maintenance	Transport services	Training, development & educ.
Legal services	Cleaning	Information technology	Transport mgt & services
Technical services	Information technology	Technical services	Research, scientific & tech.
Vehicle maintenance	Legal service	Miscellaneous	Facilities mgt
Cleaning	Technical services	Training	Financial mgt
Legal & financial	Medical services	Security	Cleaning
Media services	Waste management	Financial services	Printing & publication
Port services	Management services not elsewhere classified	Legal services	Management services not elsewhere classified
Financial services	Mail/courier services	Administration	Property mgt & services
Works related services	Correctional services	Facilities management	Executive mgt services
Management services	Financial services	Storage	Security
Property management	Administrative support	Grounds maintenance	Legal services
Security	Facilities management	Marketing	External relations
Administration	Laundry service	Vehicle maintenance	Medical services
Equipment maintenance	Training & education	Property maintenance	Audio visual services
Processing services	Vehicle maintenance	Telecommunications	Human resources
Video/photo services	Security	Printing	Administrative support

A comparison of the percentage of in-house bids (see table D.16) would indicate that in-house competition is more common at the Commonwealth level. In-house bids in Victoria “are rare as they are generally not encouraged given the government’s objective to achieve outsourcing wherever possible” (Sub. 215, p. 6).

Table D.16: In-house contracts

<i>Survey</i>	<i>Percentage of in-house bids</i>	<i>Percentage of in-house contractors</i>
WA 1995	0.7%	0.4%
NSW 1994	<1%	<0.5%
Commonwealth 1995	10.2%	1.5%

Table D.17 provides a comparison of the reasons for contracting as reported by New South Wales, Western Australia and the Commonwealth. It would appear that efficiency and effectiveness are stronger drivers in the States than the Commonwealth.

Table D.17: Reasons for contracting

<i>WA 1994</i>	<i>%</i>	<i>NSW 1994</i>	<i>%</i>	<i>Commonwealth 1995</i>	<i>%</i>
Effectiveness		Effectiveness		Effectiveness	
Very Important	62	Very Important	66	Very Important	48
		Important	30	Important	48
Efficiency		Efficiency		Efficiency	
Very Important	57	Very Important	54	Very Important	29
		Important	30	Important	31
Other		Other		Other	
Very Important (Lack of expertise)	62	Very Important	56	Very Important	85
		Important (Resource constraints, lack of expertise)	20	Important (Govt. directive, lack of expertise, resource constraints, Budget directive)	7

The surveys for New South Wales, Western Australia and Victoria have all provided information on realised average savings. However, as table D.18 shows, the sample sizes on which these estimates are based were relatively small, due to lack of accurate costings at the agency level. Savings are compared in the table but because of differences in methodology they should be treated with caution. The Commonwealth survey was the only one which separated management costs and annual contract prices. The 1995 Western Australian and Victorian surveys specifically indicated that management costs should be included as part of annual contract expenditure. The New South Wales and Western Australian surveys for 1994 did not include management costs in the savings analysis.

The estimated net savings for all four surveys, with an adjustment for management costs, are provided in column four of table D.18.

Table D.18: Comparison of savings

<i>Survey</i>	<i>No. of contracts</i>	<i>Reported savings (%)</i>	<i>Estimated Net Savings * (%)</i>
New South Wales			
1993 Budget Sector (gross savings)	170	19.95	17.65
1993 GTEs (gross savings)	85	21	18.7
1994 (gross savings)	183	19.9	17.6
Western Australia			
1994 (gross savings)	64	20	17.7
1995 (net savings)	116	24.1	24.1
Commonwealth			
1995 (net savings)	51	16.3	16.3
1995 (gross savings)	65	18.1	15.8
Defence CSP 1995 (gross savings)	49	35.7	33.4
Victoria			
1995 (net savings)	100	37.27	37.27

* Note: Estimated net savings is calculated by subtracting 2.3 per cent (Commonwealth management costs) from the gross savings results. This has been done for comparative purposes only, as management costs may vary between jurisdictions.

D.5 Conclusion

This survey revealed that the participating Commonwealth agencies contracted services to the value of more than \$1.8 billion in 1994-95. This expenditure underestimates the extent of contracting given that the survey was based on only 43 agencies and did not include GTEs. Supplementary information provided by the agencies also indicated that much contracting activity is under way which was not captured in this survey.

Comparisons with other jurisdictions showed that Commonwealth expenditure on contracted services is significantly higher than that of the States, but the distribution of expenditure across types of services was rather similar. Information technology, building maintenance services and cleaning are all regularly contracted. Of interest in the Commonwealth is the high value of expenditure on contract staff.

Contracting has always been an element of government purchasing, particularly for specialist services or those provided through common-use contracts, or inter-agency agreements. However the recent rise in first-time contracts reported in the survey suggests a significant upward trend in contracting for services.

It is not obvious that the reasons for this increase are being driven by a quest for efficiency or effectiveness. Both these reasons rated well below those reported in State surveys. Other reasons, such as the need for outside expertise and specialist services or government directives to increase private sector provision of government services, were prominent among those given by respondents.

The survey revealed dramatic savings for the Defence CSP — 35 per cent — compared with other Commonwealth agencies which reported average savings of 18 per cent. Among the States, only Victoria had a comparable result. Its average reported savings were the highest at 37 per cent. By contrast, Commonwealth agencies reported the average lowest savings, excluding Defence CSP.

Like its predecessors in New South Wales and Western Australia, this survey highlighted once again the fundamental difficulties in obtaining comprehensive data on the financial aspects of contracting. In general, the analysis of contracting outcomes is hampered by the difficulties which agencies have in compiling accurate information on the costs of service provision before and after contracting. This has the effect of reducing the sample sizes available for calculating the realised savings. Nevertheless, the results of the Commonwealth survey tell the same story as its State counterparts: savings achieved through contracting are substantial. Nor do they appear to be traded-off for lower quality of service.

Unlike its predecessors, this survey was the first to separately identify and report management costs associated with contract administration. The estimate of 2.3 per cent of annual contract costs may appear rather low, but is not out of line with figures reported by the Audit Commission in the UK. It should also be borne in mind that management costs will vary substantially between activities and agencies. However, future surveys will help provide more data which will shed further light on this important issue.

Lastly, it is interesting to observe that by revealing the information gaps that exist in the contracting area the surveys actually hasten their elimination. This was borne out by experiences with the New South Wales and Western Australia surveys which are now in their third and second round respectively. The scale and scope of the information obtained from them has improved on each successive survey round, as agencies recognised the merits of compiling such data for internal management purposes. No doubt the same will be true of the Commonwealth, and if there is one conclusion we can draw from the present exercise it is that it would be worthwhile repeating in 1996 and beyond.

Attachment A List of agencies and codes

- 1 Attorney-General's Department
- 9 Family Court of Australia
- 10 Federal Court of Australia
- 12 Human Rights and Equal
Opportunity Commission
- 19 Office of Parliamentary Council
- 20 Dept. of Communication and the
Arts
- 25 Australian Film, Television and
Radio School
- 26 Australian National Gallery
- 30 National Library of Australia
- 33 Special Broadcasting Service
- 38 Australian Hearing Services
Authority
- 40 Australian Institute of Health and
Welfare
- 50 Dept. of Industrial Relations
- 52 Australian Industrial Registry
- 53 Australian Trade Union Training
Authority
- 54 COMCARE
- 60 Australian Customs Service
- 61 Australian Institute of Marine
Science
- 68 Dept. of Primary Industries and
Energy
- 71 Defence — CSP
- 73 Dept. of Veterans' Affairs
- 76 Dept. of Employment, Education and
Training
- 77 Australian National Training
Authority
- 78 National Board of Employment,
Education and Training
- 84 Australian Sports Drug Agency
- 85 Commonwealth Bureau of
Meteorology

- 86 Great Barrier Reef Marine Park Authority
- 88 Dept. of Finance
- 89 Australian National Audit Office
- 90 COMSUPER
- 91 Dept. of Administrative Services
- 100 National Capital Planning Authority
- 101 Dept. of Prime Minister and Cabinet
- 103 Aboriginal Hostels
- 111 Office of National Assessments
- 113 Public Service Commission
- 115 Dept. of Social Security
- 116 Dept. of Tourism
- 118 Dept. of Transport
- 120 Dept. of the Treasury
- 121 Australian Bureau of Statistics
- 123 Industry Commission
- 124 Insurance and Superannuation Commission

Attachment B Service categories

Administrative support

- Photocopying
- Stores and inventory
- File management
- Word processing
- Reception duties
- Telephonist services
- Correspondence management
- Clerical work
- Form processing
- Data entry

Audio visual services

- Photography
- Video services
- Aerial photography
- Aerial mapping
- Microfilming
- Film and television services
- National mapping

Building maintenance

- Air conditioning maintenance
- Lift maintenance
- Painting
- Carpentry
- Plumbing
- Electrical
- Fire protection services
- Fire protection maintenance

Cleaning

- Building cleaning
- Street cleaning
- Graffiti removal
- Beach cleaning
- Cooling tower cleaning

Contract staff

Nursing agency
Contract teachers
Board members
Lawyers
Misc. relief staff
Operator hire
Computer personnel
Health care providers

Equipment maintenance

Machinery overhaul/maintenance
Medical equipment maintenance
Instrument maintenance
Electrical equipment
Overhaul/maintenance
Welding
Photocopier maintenance
Train maintenance
Industrial cleaning

Executive management services

Executive support
Crossportfolio liaison
Ministerial liaison
Ministerial support

Policy Advice

Economic policy
Specialist policy/strategic advice
Review
Strategies
Budget development/management
Economic studies
Management plans

External relations

Marketing
Promotions

Displays
Signage
Trade development
Media services
Advertising
Public relations
Interpreters
Subscriptions
Community consultation
Fund raising
Exhibitions
Client surveys
TV services

Facilities management

Car park management
Data centre management
Laboratory management
Warehousing and distribution
Information centre management
Base support (defence)

Financial management

Auditing
Revenue collection/control
Asset management
Funds management
Valuation Services
Financial services
Financial reporting
Debt recovery
Fraud control
Project costing/variance analysis
Stock registry
Claims analysis
Advisory service

Grounds/Reserve maintenance

Park maintenance
Gardening
Lawn mowing

Reserve upkeep
Vegetation control
Tree lopping
Landscaping

Hospitality and catering

Catering
Canteen service
Food and beverage services
Meals supply
Laundry service

Human resources

Recruitment
Occupational health and safety
Pay and remuneration
Performance management
Employee counselling
Job description and evaluation
Leave administration
Personnel policy
Induction
Workforce planning
Placements

Information management

Library services
Indexing
Archives
Audiovisual
Collections
Interlibrary loans
Journal circulation/management
Online searches
General and museum services
Press/news clipping
Records management and storage
Microfilming
Restoration
Framing

Information Technology

Software maintenance
Hardware maintenance
User support
Computer facilities management
Computer programming
Disaster planning

Legal services

Advocacy, representation
Contracts
Legal advice
Legislation development/review
Legislative drafting
Court reporting

Mail/Courier service

Distribution
Postal services
Mail services
Couriers

Management services NEC

Domestic services management
Hotel services management
Corporate services provision
Stock control/management
Pavement management
Fuel management
Seniors card management
Consulting
Total quality management
Tender assessment
Dispute resolution
Implementation
Benchmarking

Medical services

Nursing services
Radiology
Physician

Physiotherapy
Optical
Rehabilitation

Miscellaneous services

Pest control
Diving services
Beach inspection
Fencing
Shark meshing
Dredging service

Payroll processing

Printing and Publication services

Brochure design and preparation
Desk-top publishing
Document reproduction
Form design, storage and distribution
Printing
Typesetting
Book binding

Program services

Employment and training
programs (external)
Registries
Welfare services
 Residential care
 Child Care services
Trade development

Project management

Project management
Site management
Capital works management
Projects coordination

Property management and services

Property management
Building management

Housing management
Building plant management
Real estate services
Building evacuation systems
Office accommodation
Lease management
Refurbishment
Architectural and drafting services

Research, scientific and technical services

Surveys
Engineering services
Smog studies
Modelling
Inspection
Forecasting
Quality assurance
Technical services
Road design
Town planning
Market research
Scientific research
Drilling services

Security

Security services
Electronic monitoring
Security management
Attendants
Custom services

Storage

Telecommunications

Data communications
PABX maintenance
Telephone related services

Training, development and education

Training (internal)

- Computer training
- Student testing
- Design of syllabus
- Curriculum development
- Competing analysis/development
- Executive development
- Staff development
- Training needs analysis

Transport management and services

- Fleet management
- Drivers
- Bus services
- Aircraft hire
- Aircraft management
- Ferry services
- Goods transport
- Cash delivery/collection
- Relocation service
- Aircraft maintenance
- Rolling stock (train) maintenance
- Motor vehicle maintenance
- Ferry management
- Vehicle purchase and disposal
- Water craft management
- Wharf maintenance
- Ships agencies

Travel arrangements

- Accommodation
- Air travel
- Train travel
- Car travel
- Vehicle hire

Waste management

- Refuse collection
- Bulk bins services
- Liquid waste disposal
- Sewerage pumping

Attachment C Supplementary Information Provided by Agencies

The extent of contracting in Commonwealth agencies cannot be assessed without consideration of supplementary material provided by a number of the larger agencies. These include the Department of Human Services and Health, AusAID and Defence. A summary of their submissions is detailed as follows.

Department of Human Services and Health

Estimated contract values for corporate services include:

<i>Type of service</i>	<i>Annual value of contracts (million)</i>
Inter-agency contracts	\$2.46
Non-agency contracts	\$2.27
Total:	\$4.73

Inter-agency contracts include those let to the Australian Construction Services, the Australian Property Group, and to Asset Services.

Non-agency contracts cover a range of services including:

- photocopier maintenance;
- courier services;
- counselling;
- training;
- scribe services;
- interpreter services;
- auditing;
- indoor plants;
- agency staff; and
- marketing activities such as photography and design.

These figures do not include computer related services nor major advertising/publicity services.

AusAID

Although the majority of AusAID contracts are for services provided in or for other countries, information was requested for service contracts tendered in the

Australian market. Information was provided on 217 contracts let since 1 July 1994 with an average contract value \$3.5 million.

The annual contract fee cannot be calculated from AusAID's contracts register and therefore the data was not included in the survey results. The Gazette Product and Service (P and S code) service categories are used.

<i>Service Category</i>	<i>No. of contracts</i>	<i>Value of contracts (million)</i>
Consultancy, property and business services NEC	172	\$480
Health, education, museum and library services	15	\$103
Research, scientific and meteorology services	10	\$25
Community services, recreational, personal and other services	14	\$119
Other ^a	6	\$42
Total:	217	\$768

a Includes Services to agriculture, Services to mining, Transport and storage services, Communication services, and Finance, investment, insurance and related services

AusAID also reported that contracting has been an integral part of the agency's operations for many years. The majority of AusAID contracts relate to a single project, are all let to external contractors and are subject to the AusAID Activity Management Cycle which has as a component a design and feasibility stage.

The nature of AusAID activities and projects is such that there is usually no necessity for repeat contracts and therefore prior costs is not applicable. AusAID contracts are let predominantly through a public tender process.

Department of Defence

Due to the size and diversity of Defence activities, Defence was unable to provide detailed survey results on individual non-CSP contracts. Information was provided for all service contracts gazetted in the first six months of FY94/5.

Information was provided on 500 contracts worth \$937.8 million with an average contract value of \$1.88 million. As with AusAID the annual contract fee cannot be calculated from the contracts register and therefore the data was not included in the survey results. P and S code service categories are used.

<i>Service Category</i>	<i>No. of contracts</i>	<i>Value of contracts (million)</i>
Automotive services	14	\$3
Transport and storage services	22	\$2
Communication services	12	\$10
Consultancy, property and business services NEC	405	\$130
Health, education, museum and library services	6	\$1
Research, scientific and meteorology services	4	\$3
Community services, recreational, personal and other services	37	\$6
Total:	500	\$155

The Defence contracts register includes those services which, at least in peace time, have always been purchased commercially or where the decision not to continue to perform them in-house would have been taken prior to commencement of the Commercial Support Program.

Construction maintenance services were excluded as it was not possible to differentiate between construction and construction/maintenance services.

While there are no in-house bids outside the CSP program, Defence has inter-agency contracts with organisations such as DAS and Australian Property Group, and GTEs including the Australian Defence Industries.

All statements of requirements are revised or confirmed prior to the issue of tender documents. Defence selection processes emphasise value for money which includes elements of both efficiency and effectiveness.

Attachment D Core and Non-Core Services

Australian Industrial Registry

<i>Core</i>	<i>Contracted 1994-95</i>	<i>Non-Core</i>	<i>Contracted 1994-95</i>
Administration support		Administration support	
Court reporting	Yes	Building/lease management	Yes
Clerical work		Fleet management	
Library services (includes research)		Printing/copying services	Yes
Registry services			
Records management			
Data entry			
Secretarial support	Yes		
Maintenance/purchase of office equipment	Yes		
Human resource management (including payroll, training, recruitment etc)			
Mail/courier services			
Information technology support	Yes		
Executive management services		Executive management services	
Strategies		Tender assessment	
Corporate plans		Projects co-ordination	
Policy advice		Reviews	Yes

Department of Primary Industries and Energy

<i>Core</i>	<i>Contracted 1994-95</i>	<i>Non-core</i>	<i>Contracted 1994-95</i>
General administration		Building maintenance	
Project/program management	Yes	Cleaning	Yes
		Building cleaning	Yes
Technical services (ABARE, BRS, AGSO)		Equipment maintenance	
Research	Yes	Transport services	
Geological services	Yes	Aircraft hire	Yes
Drilling (on-shore/off-shore)	Yes	Grounds maintenance	
Information provision/publication	Yes	Hospitality and catering	
Publication development	Yes	Human resource management	
		IT services	Yes
		Software maintenance	Yes
		Hardware maintenance	Yes
		Computer programming	Yes
		Legal services	
		Mail/courier services	
		Mail service	Yes
		Property management	
		Security	Yes
		Security services	Yes
		Technical services	Yes
		Surveys	Yes
		Technical design	Yes
		Modelling	Yes
		Architectural services	Yes
		Research	Yes
		Analysis	Yes
		Telecommunications	
		Data communications	Yes
		Telephone/facsimile	Yes
		Waste management	Yes
		Training and education	Yes

APPENDIX E A REVIEW OF EMPIRICAL STUDIES INTO THE COST EFFECTS OF CONTRACTING

E.1 Introduction

The aim of this appendix is to review the empirical literature investigating the effect of contracting on the costs of service provision to the government. This review builds on earlier surveys by Rimmer (1993) and Domberger and Rimmer (1994).

The majority of the evidence presented in this appendix comes from studies examining the effect of contracting on the ongoing (or recurrent) costs of service provision. Although these studies cover a large range of services, many contracted services are not covered. It is unclear whether this evidence is typical of the outcomes of contracting in other services.

The services examined are provided at all levels of government. Although the majority of the studies investigate the contracting of government services in the United Kingdom and the United States, a number of recent studies focus on Australia. While the coverage of the evidence is extensive, there may be some omissions.

The appendix focuses on the effect on costs of the competitive tendering and contracting (CTC) of services by government agencies. It does not examine the effect on the costs of service provision of privatising government enterprises.

Not all of the studies reported in the appendix examine competitive tendering. Some of the evidence, especially in the United States, relates to the contracting by public agencies of services where a competitive tendering process has not been undertaken. Some studies distinguish between external and in-house contractors, while others do not. In this appendix, internal provision refers to direct service provision by a public agency when no competitive tendering process has occurred and contracting encompasses both external and in-house contractors.

In order to maintain as much objectivity as possible, only publicly available studies that are based on a verifiable data set and that use a transparent methodology are included. Other information on the effect of contracting on costs, such as from submissions to the inquiry, is included in chapter B3.

E.2 Methodologies

The empirical studies reviewed use three different methodologies to estimate the changes in costs resulting from the contracting of government services. *Before and after* and *cross-section* surveys use a sample of episodes of contracting and estimate the average or typical cost savings. This involves the use of statistical or econometric estimation techniques. *Case studies* use evidence from individual instances where services have been contracted. Each approach is described below, along with its strengths and weaknesses.

Before and after surveys

These surveys usually contain a range of information on individual contracts, including the contract costs and the costs of provision prior to contracting.

By comparing the before and after costs, one can estimate the effect of contracting on the costs of provision. This typically involves segregating contracts by service type and estimating the difference between the cost of internal provision and contracting within each service category. Statistical estimation techniques are used to estimate any cost changes.

The main advantage of this approach is that the estimated changes in costs are based on a sample of contracts, often across a number of agencies. For example, Domberger, Farago, Hall and Li (1993) estimated the cost difference between internal provision and contracting for ten services provided by the New South Wales Government. In cleaning services, for instance, they estimated that contracting reduced the costs of provision by nearly 18 per cent, using observations on at least ten contracts.

If the sample is large enough and contains sufficient information, the estimated cost effects may be useful as a guide to the average cost savings achievable in other cases of contracting.

One problem with this methodology is that for the cost comparisons to be accurate, comprehensive data is required before and after contracting. Although data on the current cost of provision may be readily accessible, data on past costs is often more difficult to obtain. Even if the data is available, costs may differ from period to period for a range of reasons other than the move to contracting. For example, changes in economic conditions, accounting systems, service levels and quality, and any reorganisation of the agency can all affect the costs of provision. As these changes are usually not controlled for in these studies, attributing the cost savings solely to contracting can be problematic.

Cross-section surveys

A second approach uses survey information on the costs of service provision at the agency level. These surveys usually report the costs incurred by each agency in providing each of its services. By comparing the costs of provision of those agencies that use contracting and those that do not at the same point in time, an estimate of the cost difference can be made. These estimates are usually made for each service type.

In undertaking these exercises, care must be taken to control for differences other than contracting, such as agency size, location, and service level and quality, which may explain differences in the costs of provision. This is achieved by including measures of these variables in a regression model. For example, using data on the costs of waste collection from local authorities in Victoria and New South Wales, Rimmer (1993) estimated the difference in the costs of collection between internal provision and contracting. In doing so, Rimmer acknowledged that the cost of waste collection depended upon factors such as the collection method employed, as well as the geographic area and the number of properties from which the waste was collected. By controlling for these variables, the estimated effect on service costs of whether the service was provided internally or by contractors, was isolated to a greater degree.

This approach is appealing from a theoretical perspective. However, in practice it requires data on the cost of provision, as well as data on a wide range of other characteristics, across a large number of government agencies. As a result, cross-section studies tend to be restricted to local government, where a sufficiently large sample can be obtained. Furthermore, some of the required data for these studies is difficult, if not impossible to obtain and proxy variables are often used as a result. Omitting important variables or using inappropriate proxies, can reduce the reliability of the estimates.

Case studies

Another way of assessing the cost effects of contracting is through case studies. Case studies are a useful way of understanding the competitive tendering and contracting (CTC) process. By performing a detailed examination of particular instances of contracting, a range of issues concerning the operation and effects of contracting which may be overlooked in surveys, can be analysed. Although the primary purpose of these studies is usually to examine the operational aspects of contracting, some studies do attempt to quantify the effect on costs.

Estimates of the effect of contracting on costs are made by comparing the costs of provision before and after the introduction of contracting. The main advantage of case studies is their scope to take full account of all or most of the costs of provision. Furthermore, by focussing on individual cases, changes in

the quantity and quality of the service provided may be identified. For example, Jensen and Hall (1995) estimated a cost saving of 84 per cent after Sydney Hospital contracted its radiology services. At the same time, the performance of the contractor radiologists, which was rated as excellent by the hospital management, was observed.

However, case studies may be of limited value when the objective is to estimate the average or typical cost savings from contracting. Case studies are often used to demonstrate instances in which contracting has either been successful or unsuccessful to a significant extent. As a result, they are selective. Therefore, care must be taken in drawing general conclusions from individual case studies.

E.3 Estimates of the effect of contracting on the costs of service provision

There is a substantial empirical literature estimating the effect of contracting on the costs of service provision. A summary of the methodology and findings of many of the major studies are reported in tables E.1 (the Australian studies) and E.2 (the international studies).

The estimated cost changes need, in the main, to be viewed as estimates of the ongoing cost changes. Very few of the studies have included estimates of the transition costs, such as redundancy payments or the costs of reorganisation, which government agencies may incur when introducing contracting. Similarly, the costs that may be incurred in conducting a tendering process and/or specifying contracts (termed transaction costs) are not included in most of the studies.

Although the methodology of the studies differ, they cover a large number of services provided by all levels of government. While most of the studies analyse the contracting of government services in either Australia, the United Kingdom or the United States, some evidence from Canada, New Zealand and Switzerland is also reported.

Collectively, these studies have been subject to a range of criticisms. Foremost is the exclusion of some relevant costs, not just the transition and transaction costs, but also, in a number of instances, some of the ongoing costs incurred in the service provision. The criticisms are discussed in E.4.

Table E.1: Estimates of cost changes from Australian empirical studies

<i>Study</i>	<i>Year</i>	<i>Service(s) & data</i>	<i>Cost change</i>
<i>Before and After Surveys</i>			
Domberger, Farago, Hall and Li	1993	Various services; data from NSW budget sector	-4% to -51% ^{ab}
Farago and Domberger	1994	Various services; data from NSW GTEs	-8% to -46% ^{ab}
Farago, Domberger, Hall and Li	1994	Various services; data from NSW public sector	-1% to -58% ^{ab}
Farago, Hall and Domberger	1994	Various services; data from WA public sector	-4% to -47% ^{ac}
Domberger, Hall and Skinner	1995	Various services; data from WA public sector	+36% to -55% ^c
<i>Cross-Section Surveys</i>			
Rimmer	1988a	Household waste collection; data from Victorian local governments	Average -17%
ACC	1988	Various services; data from SA and Tas. local governments	-9% to -46%
Evatt Research Centre	1990	Various services; data from 460 Aust. local governments	Not provided
Albin	1992	Various services; data from 58 local governments	Not statistically different from zero
Rimmer	1993	Various services; data from a survey of 327 NSW & Victorian local governments, with supplementary data from other sources	-1% to -53% ^d +18% to -45% ^e Not statistically different from zero ^f
Domberger, Hall and Li	1995	Cleaning services; data from Sydney region	-49% to -53% ^g Not statistically different from zero ^h
<i>Case studies</i>			
Rimmer	1988b	Various services; data from Brisbane City Council	-5% to -54%
Rimmer	1991c	Road sealing & street sweeping; data from Glenorchy City Council	-10% to -15%
Hall and Domberger	1995	Cleaning services; data from NSW hospitals	-15% to -30% ⁱ
Jensen and Hall	1995	Radiology services; data from Sydney Hospital	-84%
Jensen and Liebenberg	1995	Government Cleaning Service; data from NSW Government	-31% ^j
Dixon and Jensen	1995	Road maintenance; data from NSW RTA	-34%

- a A small number of cost increases have not been included in these studies. The authors argue that the majority of these cost increases resulted from changed requirements in the contract specifications.
- b Only those services for which there were cost data for at least five contracts are included.
- c Only those services for which there were cost data for at least three contracts are included.
- d Estimates the change in costs for each service using the sample mean.
- e Estimates the change in costs for each service using the sample median.
- f General result of the multiple regression analysis. The only case in which a contracting variable was statistically significant was in waste collection in Victoria, where contracting was estimated to increase costs by 7 per cent.
- g These are estimates for cleaning in schools. The school sample was divided into two groups — special schools, which require a higher standard of cleaning, and all other schools. The larger cost saving estimate was found for special schools.
- h Estimates for cleaning in hospitals and offices.
- i These estimates are for savings on recurrent expenditure. Another hospital was also the subject of a case study. While cost savings were also found in that case, the performance was unsatisfactory and the contract was terminated after nine months.
- j Projected savings by the third year of operation. This estimate does not include possible redundancy costs.

Table E.2: Estimates of cost changes from international empirical studies

<i>Study</i>	<i>Year</i>	<i>Service(s) & data</i>	<i>Cost Change</i>
<i>Before and After Surveys</i>			
Confederation of British Industry (UK)	1988	Various services; central government and National Health Service data	-9% to -23%
Walsh (UK)	1991a	Various services; data from local governments	+6% to -17%
Walsh and Davis (UK)	1993	Various services; data from local governments	+3% to -13%
Citizen's Charter (UK)	1995a	Various services; data from central government departments	-16% to -33%
<i>Cross-Section Surveys</i>			
Spann ^a (US)	1977	Waste collection; data from Monmouth County	Average -30%
Savas ^a (US)	1977a	Waste collection; data from nationwide survey of cities	-9%
Pommerehne and Frey ^a (Switzerland)	1977	Waste collection; data from 103 cities	-20%
Edwards and Stevens ^a (US)	1978	Waste collection; data from 77 cities ^b	-29% -9% ^c
Kramer and Terrell (US)	1984	Social welfare services; data from San Francisco Bay Area local governments	Not provided
Stevens ^a (US)	1984	Various services; data from Los Angeles district	-27% to -49% ^d

Table E.2: Estimates of cost changes from international empirical studies (cont.)

<i>Study</i>	<i>Year</i>	<i>Service(s) & data</i>	<i>Cost Change</i>
McDavid ^a (Canada)	1985	Waste collection; data from nationwide survey of cities	-29%
Mehay and Gonzalez ^a (US)	1985	Law enforcement; data from California counties	-9% -20% ^e
Domberger, Meadowcroft and Thompson (UK)	1986	Waste collection; data from local governments ^f	-22% ^g -17% ^h
Audit Commission (UK)	1987	Various services; data from local governments	-15% to -25%
Domberger, Meadowcroft and Thompson (UK)	1987	Hospital services; data from hospitals ^f	-34% ^g -22% ^h
Milne and McGee (UK)	1992	Hospital services; data from a regional health authority	Not statistically different from zero
Szymanski and Wilkins (UK)	1993	Waste collection; panel data from UK authorities ^f	-11% ^g -22% ^h
<i>Case Studies</i>			
Savas ^a (US)	1977b	Waste collection; data from the City of Minneapolis	-13% ⁱ +1% ^j
Berenyi ^a (US)	1981	Waste collection; data from 10 cities	-7% to -49%
Straussman and Farie ^a (US)	1981	Social services; data from Monroe County, NY	Average -31%
Hartley and Huby (UK)	1986	Various services; data from local & health authorities	+28% to -68%
Ascher (UK)	1987	Various services; data from Wandsworth Council	-6% to -58%
Pack (US)	1989	Various services; data from 15 cities & counties	-5% to -50%
Brimble (New Zealand)	1994	Various services; data from Dunedin C.C.	Average -15%

- a It is unclear whether any competitive tendering process was conducted by agencies in these studies before contracting the services.
- b The comparison of the costs of contracting in this study is with other private institutional arrangements.
- c Adjusted for possible scale economies.
- d The cost difference for one service, payroll preparation, was not found to be statistically different from zero.
- e Estimation using two stage least squares (2SLS).
- f Domberger, Meadowcroft and Thompson (1986, 1987) used pooled data for two years. Szymanski and Wilkins (1993) pooled five years of data and also analysed the cross-section data for each year.
- g Estimates when the service was competitively tendered and won by an external contractor.
- h Estimates when the service was competitively tendered and won by an in-house team.
- i In the first year of dual provision by city workers and contractors.
- j In the fifth year of dual provision.

Does the evidence suggest that contracting changes the costs of service provision?

The evidence presented in tables E.1 and E.2 suggests the contracting of government services generally results in ongoing cost savings.

Despite the heterogeneity of the studies, approximately 75 per cent estimated that contracting reduced the costs of provision. Findings of no cost savings, or cost increases, were restricted to only a few of the studies. Furthermore, the range of any estimated cost increases tended to be smaller (from 0 to 28 per cent) than the range of cost savings (from 0 to 84 per cent).

Although most studies estimated cost savings, the range and variability of the estimates are large. Such diversity in the size of the estimated cost changes would appear to demonstrate that no useful 'rule of thumb' exists on the size of the probable effect of contracting on the costs of provision. Rather, it appears each instance contains unique characteristics which influence its success or otherwise (in cost terms).

This variability is evident within studies as well as across studies. For instance, Hartley and Huby (1986) used a sample of local governments and health authorities in the UK to estimate the effect of contracting.¹ Their estimated cost changes ranged from an increase of 28 per cent to a reduction of 68 per cent.

Despite the wide range of estimates, table E.3 indicates that just over half of the 203 individual services examined in the studies yielded estimated cost savings of between 10 and 30 per cent. The remaining estimates were distributed reasonably evenly on either side of this range, with a small skewness towards a lower level of savings or cost increases.

It should be noted that the studies with estimates reported in table E.3 vary in quality. For example, estimates from studies making use of a substantial number of observations may be more reliable than those using only a few (or as in case studies, just one). Similarly, some studies account more fully for the relevant costs than others, or use better quality data. These issues and their possible implications are discussed elsewhere in this appendix. However, the estimates from the studies that are likely to be more accurate do not appear to show any systematic difference from the group as a whole.

¹ For the purpose of analysing the change in service costs, Hartley and Huby only used those cases from their survey where contractors were to supply the same level of service as previously supplied by the in-house unit.

Table E.3: Estimates of cost changes from contracting

<i>Range of cost change estimates</i>	<i>Estimates in each range</i>	<i>Percentage of total estimates</i>
Greater than 10% increase	2	1.0%
10% increase to no change	20	9.9%
No change to 10% reduction	35	17.2%
10% to 20% reduction	54	26.6%
20% to 30% reduction	48	23.6%
30% to 40% reduction	16	7.9%
40% to 50% reduction	20	9.9%
Greater than 50% reduction	8	3.9%
Total	203	100%

Note: The estimates included in this table consist of all individual service estimates reported in the studies listed in tables E.1 and E.2.

The size of the cost changes implied by this table are consistent with the results from a meta-analytic review of the literature conducted by Hodge and Russell (1995). Meta-analysis uses statistical information from existing studies to test for the existence of a relationship between two variables; in this case the ‘cost of service production’ and the ‘contract arrangement’. Using 49 estimates from 23 studies (with a combined sample size of 19,967 observations), Hodge and Russell concluded that there was a statistically significant relationship between the ‘cost of service production’ and the ‘contract arrangement’, and that contracting reduces average costs.²

The evidence reviewed in this appendix suggests that, in general, contracting reduces the ongoing costs of service provision. However, the actual size of these savings is highly variable.

Do the estimated ongoing cost changes differ by service type and market characteristics?

As demonstrated in tables E.1 and E.2, a wide range of cost changes have been estimated across a number of services. This suggests that the extent of achievable cost savings may differ by the type of service or the characteristics of the market of potential service providers.

A theme of some of the empirical literature is that the degree of competition for the contract may be a determinant of the level of cost savings. Some services may lend themselves more readily to the creation of competitive pressures than others.

² The analysis was restricted to the studies that provided the relevant statistical information.

There is some evidence that the cost savings from contracting tend to be correlated with the characteristics of the labour and capital used to provide the service. The cases in which Pack (1989) found cost savings in excess of 20 per cent were mostly landscape maintenance or custodial services, tasks which required less skilled labour. She observed:

... cost savings are greater where competitive bidding occurs and competitive bidding is more likely when the good or service to be purchased is commonly available privately or is a simple product, with a straight forward production process, in which skilled labour, and capital equipment requirements are minimal and there is, thus, little uncertainty about costs. (Pack 1989, pp. 10-11)

However, there is also some evidence to suggest that significant cost savings are achievable in services requiring highly skilled technicians. The study of the contracting of radiology services at Sydney Hospital by Jensen and Hall (1995) provided the largest estimated cost saving (84 per cent) reported in any of the studies reviewed.

Sunk costs incurred in providing the service may also affect the achievable cost savings.³ The existence of sunk costs can be an effective barrier to market entry and as a result can reduce the competition among tenderers. Factors such as the capital and technology requirements of the service provision, their alternative uses and the ease with which they can be secured from other sectors, will determine the extent of sunk costs in providing individual services (Domberger, Meadowcroft and Thompson 1987).

Despite the commentary in the studies surrounding differences in the cost savings achievable by service type, the evidence is not sufficiently strong to draw any firm conclusions. Looking across studies, the estimated changes in costs from contracting any one service are not uniform. For example, for waste collection the estimated cost changes ranged from a 7 per cent increase to a 49 per cent reduction. Although it would appear that, in general, ongoing cost savings are achievable from contracting waste collection, it is difficult to determine from the empirical evidence if high or low cost savings can be won.

Even within the same country and level of government, estimates of the cost savings from the contracting of particular services vary widely. For example, Domberger, Farago, Hall and Li (1993) estimated the cost savings achieved by the NSW Government from contracting building maintenance services in its budget sector, were in excess of 50 per cent. However, using the same

³ Sunk costs are costs incurred in purchasing resources, especially plant and machinery, which cannot be recovered by selling or renting the resource. Such a resource effectively has no alternative use and once purchased, its economic cost is zero.

methodology the following year for the entire NSW public sector, the cost savings were estimated to be less than 10 per cent.⁴

While the cost changes from contracting vary, the available empirical evidence does not provide sufficient information to determine whether the service type or market characteristics drive these differences.

Do the estimated cost changes differ between countries?

Of the studies examined, approximately 40 per cent analysed contracting in Australia. The estimated effects of contracting on costs reported in the Australian studies are very similar to those in the other countries examined (principally the UK and the USA).

As with the international studies, most Australian studies found that contracting reduced the costs of service provision. Similarly, the estimated cost effects were variable, mostly ranging between no change and a 50 per cent saving.

Nevertheless, in line with the international studies, some Australian studies estimated cost increases from contracting. Rimmer (1993), with one of three estimation methods he employed, estimated that the cost of providing sanitation services in Victoria and the provision of halls and civic centres in New South Wales increased (by 18 per cent and 9 per cent, respectively) as a result of contracting.⁵ Furthermore, the Evatt Research Centre (1990), in its national survey investigating the advantages and disadvantages of local governments contracting out services, reported that the majority of the 460 respondents indicated that they thought costs had increased as a result of contracting. These findings reinforce the international evidence which suggests that contracting, while reducing costs in most cases, can lead to cost increases in some instances.

Despite institutional and other differences between the United States, the United Kingdom and Australia, the evidence does not suggest substantial differences in the cost effects from contracting across these countries.

Do the estimated cost changes differ in the short and long run?

Few studies have investigated whether cost savings from contracting are similar over the short and long run. Such an analysis requires cost data over a reasonable time span. Not only is the cost data required immediately before and

⁴ The public sector includes the budget sector and government trading enterprises (GTEs). Farago and Domberger had estimated cost changes for GTEs separately for the initial year (1992-93). Their estimate of the cost savings for building maintenance contracts was 19 per cent. Combining this estimate with that of Domberger, Farago, Hall and Li reduces the disparity between the estimates to some extent, but a considerable difference still remains.

⁵ These estimates were obtained using the sample median.

after the initial contracting, but also some period (eg five years) later. As a result, the evidence on any differences in the cost effects in the long run is limited.

There are many interpretations of long-run cost changes. One interpretation is based on the difference between the *current* cost under contracting and the cost of internal provision *prior* to contracting. That is, a fixed base of internal provision costs is compared with the costs of contracting over time. In this case cost savings will increase over time if the cost under contracting decreases over time with subsequent tender rounds.

Another interpretation is based on differences between the *current* cost under contracting and the estimated amount it would cost if *currently* provided internally. That is, a moving base of internal provision costs is compared with the costs of contracting over time. Here cost savings will depend upon movements in both these costs. Table E.4 will help demonstrate the possible cases.

Table E.4: Different scenarios showing the costs of internal provision and contracting

	<i>Scenario 1</i>	<i>Scenario 2</i>	<i>Scenario 3</i>	<i>Scenario 4</i>
Internal provision in period 0	100	100	100	100
Internal provision in period 1	100	100	100	100
Contracting in period 1	80	80	80	80
Internal provision in period 2	100	90	90	90
Contracting in period 2	70	80	72	90

Note: It is assumed that only internal provision existed in period 0, with contracting beginning in period 1.

In scenario 1, the cost of internal provision remains the same over time, but the cost of contracting decreases. As a result, cost savings increase from 20 per cent in period 1 to 30 per cent in period 2, irrespective of whether the fixed base or moving base is used.

In scenario 2, the cost of internal provision decreases over time and the cost of contracting remains the same. In this case, cost savings remain at 20 per cent over time with the fixed base comparison, but decrease to 11 per cent in period 2 if the moving base comparison is used.

Scenario 3 shows the cost of both internal provision and contracting decreasing over time. If the fixed base comparison is used, the contracting cost savings

have increased from 20 per cent in period 1 to 28 per cent in period 2, whereas the savings remain constant at 20 per cent with the moving base comparison.

The final scenario shows the costs of internal provision decreasing over time and the costs of contracting rising over time. In the fixed base comparison, the cost savings fall from 20 per cent in period 1 to 10 per cent in period 2. Using the moving base comparison, the cost savings fall to 0 per cent in period 2.

In the empirical literature, both methods of comparison are used to measure the cost changes over time. The shortcomings of one method are the strengths of the other. The fixed base method will be inaccurate if costs associated with delivering the service have altered over time because of factors other than contracting. The moving base method will be inaccurate if the costs of those agencies providing the service internally have changed over time as a result of the contracting by other agencies.⁶

The available evidence predominantly comes from international studies. This reflects, in part, the longer history of research into the effects of contracting overseas than in Australia — and that reflects the fact that policies encouraging the widespread use of contracting have been in place overseas, particularly in the United Kingdom, for some years. Although limited in their breadth, these studies tend to indicate that any cost savings from contracting may decrease over time.

In the study by Savas (1977b) the costs of waste collection by private contractors and municipal providers in the City of Minneapolis were observed concurrently for five separate years from 1971 and 1975.⁷ Comparing costs using a moving base, the author found that, in the first year, the costs of private contractors were 13 per cent lower. However, four years later this situation had reversed, with the municipal providers being marginally cheaper. Savas noted that this was mainly due to a reduction in the costs of providing the service internally, rather than an increase in the cost of private provision. He hypothesised that the introduction of competition in 1971, or the threat of its further use, was sufficient incentive for the internal providers to reduce their costs.

Pack (1989) analysed 15 instances of the contracting of services by city and county authorities in the United States. The cost savings from contracting in 1983 were compared with those four years later. The cost differentials were estimated using a moving base by comparing the actual cost of contracting and

⁶ This could occur if the success of contracting by other agencies provides the motivation and means for an agency to improve its performance.

⁷ In this study the city's waste collection was divided between private contractors and the municipality's internal providers.

estimates of the internal provision costs that would have prevailed at the same time. The author conceded that the accuracy of the cost estimates for internal provision in 1987 were questionable.⁸ In most instances, the extent of estimated cost savings diminished over time. For example, the cost of contracting landscape maintenance in Pasadena, California was initially estimated to be 50 per cent below the cost of internal provision. Four years later this estimate had fallen to 20 per cent. For four of the 15 contracts it was estimated that none of the original cost savings were retained. It is unclear whether the reduced cost savings reported in this study were due to increased contracting costs, lower estimated costs of internal provision, or a combination of both.

Szymanski and Wilkins (1993) analysed cost savings over time, using annual data on the costs of waste collection by local authorities in the United Kingdom. The data covered the period from 1984 to 1988 and the sample included observations of contracting and internal provision in each year, allowing a comparison of costs at the same point in time (ie using a moving base). The authors found that the savings from contracting increased during the first three years, but then began to decline. The authors attributed the increased cost savings in the second and third years to the reorganisation costs incurred by agencies during the first year of contracting. Over the longer term the evidence suggested that the reduction in cost savings was partly attributable to the falling real costs to agencies of providing the service internally. Underbidding (either accidental or deliberate) by contractors in the original tender processes was cited as another possible cause (Szymanski and Wilkins 1993).

Comparing contracting costs using a fixed base, Brimble (1994) found that some of the cost savings first attained by the Dunedin City Council from the contracting of road, drainage and water works were not sustained. He maintained that this was due to the loss-leading pricing strategies of some contractors who attempted to drive out competitors in order to secure a degree of market power and raise their contract prices when they were retendered. While this strategy was found to be unsuccessful (as the majority of contracts were awarded to other firms when retendered), the original cost savings were not sustained. When the contracts were re-tendered, the winning bids were higher and, the author claimed, more accurately reflected the true cost of service delivery. As a result, the savings realised by the Council, which were initially in the order of 20 per cent, declined to an average of 15 per cent.

Rimmer (1993) used Australian data to estimate the short-run and long-run cost changes of contracting. Using a moving base, he compared the costs of local

⁸ The estimated costs of internal provision in 1987 were based, in most cases, on limited information. Many of the authorities had not retained the capacity to accurately estimate these costs.

governments providing services internally with the costs of local governments providing the services under contracting. Rimmer estimated the cost changes according to the period in which the local government first contracted the service. The only service in which his results revealed a statistically significant cost change at any point in time was in the construction and maintenance of roads and bridges where costs increased from contracting. However, there was no discernible difference between the short-term and long-term cost changes.

The evidence suggests that cost savings are obtained over the long term, although they may be higher in the short term. Two main reasons have been given for any observed reduction in savings over time. First, contractors may initially submit tenders at unsustainably low prices, either through incomplete knowledge of the full costs of providing the service, or through loss-leading pricing strategies. Second, the cost of internal provision may fall over time, possibly as a consequence of the (actual or threatened) competition provided by contractors.

Do the estimated cost changes differ depending on the methodology employed?

The only notable difference in the estimated cost changes across methodologies is that, on balance, the estimates from the regression analyses using cross-section data show a greater degree of consistency. This is probably due to the fact that, by using regression analysis, these studies are able to control for the influence that factors other than contracting have on the costs of provision. Among these studies are Pommerehne and Frey (1977), Edwards and Stevens (1978), Stevens (1984), McDavid (1985), Mehay and Gonzalez (1985), Domberger, Meadowcroft and Thompson (1986, 1987), Audit Commission (1987), Albin (1992), Milne and McGee (1992), Rimmer (1993), Szymanski and Wilkins (1993) and Domberger, Hall and Li (1995).

The estimates reported in these studies are, as a group, more tightly clustered than any other identifiable grouping. Nine of these studies estimated the cost savings from contracting at between 9 and 49 per cent, with the majority of estimates between 15 and 30 per cent.

The four exceptions among the group — Albin (1992), Milne and McGee (1992), Rimmer (1993) and Domberger, Hall and Li (1995) — reported either no statistically significant change in costs under contracting or relatively large cost savings.

For the most part, the estimates of the effect of contracting on costs appear to be similar across studies employing different methodologies.

Does the cost change differ if the contract is awarded to an in-house team or an external contractor?

Some studies have concluded that the most important element required to achieve cost savings is not the provision of services by external contractors, but the existence of a competitive tendering process in which prospective contractors can tender for the work.⁹ In a number of cases, in-house teams have won contracts and realised cost savings comparable to those achieved by external contractors.

This was found by Domberger, Meadowcroft and Thompson (1986) in their repetitive study into the contracting of waste collection. Although the estimated cost saving from external contractors was 22 per cent compared with 17 per cent for successful in-house tenderers, the cost differential between the two was not statistically significant. This finding was reinforced by Szymanski and Wilkins (1993), who presented evidence to suggest that the cost savings achieved with successful in-house tenderers may be greater than those achieved by employing external contractors. In one model specification the estimated cost savings for successful in-house tenderers was 22 per cent compared with an 11 per cent cost saving for external contractors.

The evidence does not suggest that any cost savings are lower if the contract is won by an in-house team.

E.4 Criticism of the studies

Criticism of these studies is directed at their methodology and the validity of the conclusions drawn from the estimated results.

Are all of the relevant costs included in the studies?

It is necessary to take account of at least the major costs of internal provision and contracting and to measure them correctly, if an accurate estimate of the change in costs from the introduction of contracting is to be obtained.

It would appear that none of the studies listed in tables E.1 and E.2 have accounted for all the relevant costs. At times there may be difficulties in obtaining any, let alone worthwhile, information on some costs. Nevertheless, their omission may compromise the accuracy of the estimated cost savings.

⁹ See, for instance, Domberger, Hall and Li (1995) and Brimble (1994).

In general, the studies have concentrated on comparing the ongoing costs of internal provision with those of contracting, including the payments made to contractors.

To estimate the ongoing costs of internal provision, accurate information on the direct labour costs and energy and material costs is usually relatively easy to obtain. However, items such as capital costs, administrative costs, internal management costs and components of indirect labour costs may be underestimated or not available. For example, McDavid (1985), in his study of waste collection in Canada, found that cost information received from public agencies in his national survey tended to omit capital expenditure, debt retirement and rent.¹⁰

When estimating the ongoing costs under contracting, the contract price is usually easy to obtain. However, simply taking the contract price as the total cost of contracting to the public agency is misleading and may underestimate the true cost. Apart from the actual contract payments, there are other ongoing costs, principally the monitoring costs associated with the contract. It appears that the majority of studies have not included monitoring costs. Walsh and Davis (1993) estimated that these costs amount, on average, to approximately 6 per cent of the contract value.¹¹

It is likely that costs of a similar nature would also be incurred in monitoring internal provision. If these costs are also omitted from a cost comparison, there will be no bias in the estimated cost changes if the monitoring costs are of the same magnitude for both internal provision and contracting. However, it is difficult to determine how similar they are, as there is very little evidence regarding the relative size of the monitoring costs associated with internal provision and contracting.

In most of the studies, the costs of the contracting process incurred by public agencies were also overlooked. Walsh (1991a) estimated that the initial costs of preparing for competition amounted to about 2.5 per cent of the total contract value. Approximately half of the preparation costs were considered to be one-off costs, as:

¹⁰ Savas (1977a) also noted that some labour, capital and overhead costs which could be correctly attributed to internal provision were omitted from the calculation of the costs of New York City's waste collection service.

¹¹ In some recent research there has been an attempt to measure monitoring costs. For example, in the most recent surveys conducted by the Victorian Government (the results of which were not available for inclusion in this appendix) and for the Western Australian Government (Domberger, Hall and Skinner 1995), information on the extent of monitoring costs associated with contracts was requested. In the survey of Commonwealth agencies conducted for this report, agencies were asked to include the estimated costs of setting up and monitoring contracts (see appendix D).

Much of the ground work that is done the first time contracts are let will not have to be done again. There will also be some continuing cost incurred each time a contract is tendered, for example, for re-measurement and for letting the contract. (Walsh 1991a, p. 130)

Walsh and Davis (1993) revised this estimate to 1.8 per cent of the total contract value, although they noted that this was likely to be an underestimate because the opportunity cost of the time spent by authority staff in organising the contracting process was not included. There is also some evidence that the costs of the contracting process are subject to economies of scale, with their importance decreasing as a proportion of the total contract value let by public agencies as the contract value increases in absolute terms.

The omission of the costs incurred in the contracting process will exaggerate any estimated cost savings from contracting. However, if the scant evidence available is accurate and representative, the significance of this bias may be fairly minimal.

Very little emphasis has been given in the empirical literature to the transition costs incurred by public agencies when moving from internal provision to contracting.¹² Their exclusion may reflect the difficulty in obtaining accurate information on the extent of these costs. The Citizen's Charter (1995a) study of the 'Competing for Quality' program being undertaken by the British Government is the only study included in this review which appears to adequately incorporate transition costs, such as redundancy payments and reorganisation costs, into their estimates. With their inclusion, cost savings ranging from 16 to 33 per cent were still found.

The omission or incorrect measurement of some costs may be the most serious deficiency in many of the studies reviewed. While there has often been a failure to account properly for all of the ongoing costs of contracting, a similar argument can also be made with regard to the ongoing costs of internal provision.

The almost universal exclusion of transition costs and, to a smaller degree, the costs incurred in the tendering and contract process means that, in most cases, the cost changes reported in the studies should be viewed as estimates of the differences in ongoing costs before and after contracting. The additional costs, especially the transition costs, will vary in magnitude from one case to the next. However, their omission will result in a lower estimate of the costs of contracting than is really the case.

¹² This is not to say that the transition costs have been ignored entirely. For instance, Walsh (1991a) recognised his estimates did not include all of the possible costs, including redundancies.

Whether the exclusions and incorrect measurements result in a substantial overestimate of the cost savings from contracting will depend upon the relative size of the omissions and inaccuracies in each study. It may be reasonable to assume that the majority of studies examined, due to the omission of transition costs, have overestimated any cost savings from contracting. However, the evidence of the likely size of any omitted costs suggests that their inclusion will not alter the conclusion, in most cases, that contracting reduces the costs of service provision for public agencies.

Are any cost savings at the expense of service quality?

The argument is sometimes advanced that cost savings are achieved, at least partially, through a decline in service quality.

In some instances, there may be a deliberate decision to reduce service quality. Governments may decide, when contracting a service, that the quality of service previously delivered is no longer essential, or even desirable. That decision will be reflected in the contract specifications. In other cases, a decline in service quality may be the result of the contractor failing to meet the specifications, or the consequence of poorly defined specifications.

Assessing changes in service quality presents considerable difficulties. Rating quality often involves some degree of judgment and/or the use of imperfect performance indicators. As a result, a precise estimate of the effect of contracting on the quality of service provision is seldom available. Nevertheless, two approaches have been taken in the literature to address this issue.

The first approach has been to obtain measures of the quality of the service and attempt to control directly for the effect of quality differences on the costs of provision using regression analysis. This has typically been done in cross-section studies where the quality and quantity of service can differ across agencies. By including measures of quality and quantity in a regression model, the effect of contracting on the cost of providing the same level and quality of service can be identified. For example, Domberger, Meadowcroft and Thompson (1986) included the collection method and frequency as measures of service quality in their study of waste collection costs by local authorities in the United Kingdom.¹³

¹³ Paddon (1991) has, in turn, criticised their use on the basis that they are not independent measures of quality. He argues that both the method and frequency of collection are determined by the contract specifications and that more pertinent measures of quality might include such things as missed collections and refuse spillage.

Unfortunately, only a few international studies control for quality differences in their regression analysis.¹⁴ The estimated cost savings from these studies are similar in magnitude, if not slightly larger, than the cost savings estimated in other cross-section studies or the before and after studies. This would appear to provide some evidence that the cost savings from contracting were not due to reductions in service quality. However, the proxies for quality used in the studies are only approximate measures and may not fully capture all aspects of quality.

A second approach has been to observe directly the quality and service levels and compare them across agencies using internal provision and those contracting the service. The results of these studies are summarised in tables E.5 (the Australian studies) and E.6 (the international studies).

In estimating the effect of contracting on service quality, the studies have used information from one or more of three sources. The first source is the direct response of service consumers. In the study of waste collection in Minneapolis, Savas (1977b) used the number of customer complaints as a proxy for service quality.

The second source is independent observation and assessment. Both Stevens (1984) and Domberger, Hall and Li (1995) employed trained observers to visit contract sites to assess quality. Performance indicators from these assessments were then constructed.

The final source is information from contract managers. Such information may not be entirely objective. However, this problem arises, to some extent, whether the contract managers or other groups rate the service quality.

The estimated effect of contracting on service quality varies across studies. The Evatt Research Centre (1990) reported that many respondents to its survey of local councils in Australia were of the opinion that contracting resulted in a deterioration in the quality of service. Hartley and Huby (1986), Ascher (1987) and Pack (1989), all international studies, provide some collaborating evidence of quality decline. Hartley and Huby (1986) reported a number of instances where penalty clauses had to be invoked against contractors. Ascher (1987) observed a variety of quality outcomes, with the finding in the majority of cases that quality declined. Pack (1989) found that, in three of the fourteen cases that

¹⁴ Many of the cross-section studies that employ regression analysis, including the Australian studies, control for characteristics other than service quality (such as the size of the local government area in the case of waste collection). Only four international studies control for service quality — Pommerehne and Frey (1977), Stevens (1984), Domberger, Meadowcroft and Thompson (1986) and Szymanski and Wilkins (1993).

could be examined, unsatisfactory quality led to the termination of the contract or the threat of such action.

Three studies reported that quality did not change as a result of contracting. Stevens (1984) and Farago, Hall and Domberger (1994) concluded that the cost savings found across a range of services did not result from reductions in quality. Savas (1977b) claimed that the service provided by contractors and municipal waste collectors in Minneapolis had both improved by similar amounts compared to the pre-existing service.

Table E.5: Estimates of service quality changes from Australian empirical studies

<i>Study</i>	<i>Year</i>	<i>Service(s) & data</i>	<i>Quality Change</i>
Rimmer	1988a	Cleaning services; data from 13 Victorian local governments	No change or improved
Evatt Research Centre	1990	Various services; data from 460 local governments	Often reduced
Domberger, Farago, Hall and Li	1993	Various services; data from NSW budget sector	No change or improved ^a
Rimmer	1993	Various services; data from 31 NSW and Victorian local governments	Varied outcomes, more often reduced ^b
Farago, Domberger, Hall and Li	1994	Various services, data from NSW public sector	No change or improved ^a
Farago, Hall and Domberger	1994	Various services; data from WA public sector	No change ^a
Domberger, Hall and Li	1995	Cleaning services; data from Sydney region	35% improvement ^c Not statistically different from zero ^d

a Respondents were asked to rate the effectiveness of the outcome of each contract. Effectiveness was defined as 'to ensure service delivery'. The findings are based on the high proportion of responses stating that the effectiveness of the outcome had either been successful or very successful.

b Councils were asked to list the advantages and disadvantages of contracting. Seven indicated that quality had improved with contracting, while 24 indicated that it had declined.

c Estimate for the quality of cleaning in special schools.

d Estimate for the quality of cleaning in offices, hospitals and the remaining schools in the sample.

The study by McMaster (1995) into changes in service quality following contracting showed varied outcomes. Of 199 contracts examined, the standard of services delivered was considered (by senior management of the tendering authorities) to be unchanged in 113; to have deteriorated in 47; and to have improved in 39. There was also some evidence that, in cases where cost savings were achieved, the probability of service quality improvement declined.

However, the evidence did not suggest that cost savings were associated with service quality deterioration.

Table E.6: Estimates of service quality changes from international empirical studies

<i>Study</i>	<i>Year</i>	<i>Service(s) & data</i>	<i>Quality Change</i>
Savas (US)	1977b	Waste collection; data from the City of Minneapolis	No change
Stevens (US)	1984	Various services; data from Los Angeles district	No statistically significant difference
Hartley and Huby (UK)	1986	Various services; data from local & health authorities	Some evidence of quality decline
Ascher (UK)	1987	Various services; data from local governments	Varied outcomes, more often reduced
Pack (US)	1989	Various services; data from 15 cities & counties	Approximately 25% with quality problems
McMaster (UK)	1995	Various services; data from local govt. & health authorities	57% no change 20% quality improved 23% quality problems

The remaining four studies — Rimmer (1988a), Domberger, Farago, Hall and Li (1993), Farago, Domberger, Hall and Li (1994) and Domberger, Hall and Li (1995) — all indicated that, in some instances, there was evidence to suggest that service quality may have improved with contracting.¹⁵ In addition, Domberger, Farago, Hall and Li (1993) found that those contracts which reduced costs also tended to improve quality.¹⁶ Domberger, Hall and Li (1995), in their analysis of cleaning contracts in the Sydney area, used regression analysis to assess the effect of contracting on performance. For hospital, office and most school cleaning they could not reject the hypothesis that contracting had no effect on the performance level. However, for cleaning in special schools they estimated a 35 per cent improvement in performance from contracting.

As can be seen, the extent of formal research into the quality effects of contracting is limited. Much of the information on this issue is of an anecdotal nature. The views of inquiry participants are presented in chapter B1.

In practice it is impossible to account fully for all differences in quality (and quantity) when making cost comparisons. The available evidence on

¹⁵ The studies by Farago, Hall and Domberger (1994), Domberger, Farago, Hall and Li (1993) and Farago, Domberger, Hall and Li (1994) all use the same methodology.

¹⁶ This finding has been criticised by the Public Sector Research Centre (Sub. 214) for being based on inappropriate statistical procedures.

the effect of contracting on the quality of service provision is varied, ranging from quite significant deterioration to substantial improvement in quality. At the same time, other studies have estimated the cost changes from contracting while attempting to hold the quality of service constant by using regression analysis. While these latter studies have been unable to comprehensively account for all aspects of quality, they do not indicate that the cost savings from CTC are at the expense of service quality.

Are the studies statistically accurate?

One major problem with many of the empirical studies is the apparent confidence in the size of the estimates. Estimates based on a sample of contracts or agencies are, by their nature, variable. By taking a different sample the estimated cost change will vary. The question remains whether the sample is sufficiently representative to make accurate inferences about the cost effects of contracting across the population of contracts or agencies. The best way to investigate this is by using the standard errors of the estimates to perform hypothesis tests. Of particular interest is whether the evidence in the sample is sufficiently strong to suggest contracting does in fact reduce costs.

Unfortunately, none of the before and after studies report either the standard errors of their estimates or the results of any hypothesis tests. As a result, some caveats must be placed on any conclusions drawn from their estimates. For example, Farago, Domberger, Hall and Li (1994) estimated an average cost saving from contracting transport services in the order of 15 per cent, based on a sample of approximately ten contracts.¹⁷ The total population of transport service contracts reported in the survey was 3154. It is difficult to draw meaningful inference from such a small sample of the population.

Among the cross-section studies, a number of the estimates of cost savings were statistically different from zero. These included Pommerehne and Frey (1977), Stevens (1984), McDavid (1985), Mehay and Gonzalez (1985), both studies by Domberger, Meadowcroft and Thompson (1986, 1987) and Szymanski and Wilkins (1993).

Where sufficient information was provided, tests tended to support the hypothesis that contracting reduces the costs of service provision.

¹⁷ The exact number is not given, however the savings estimates were only given for those services with at least five observations. It can be reasonably assumed that the actual number would not have been far in excess of ten observations.

Do any cost savings depend on the stage of the economic cycle?

It has been suggested that the cost savings, if any, resulting from contracting are correlated with the broader economic conditions prevailing at the time. When the economy is growing strongly, contractors may have a greater range of work opportunities. As such, the extent of the competition for any one contract may diminish. In addition, stronger demand may impose inflationary pressures on wages and other factor costs. The result could be higher tender bids and reduced savings (or even additional costs) from contracting. On the other hand, when economic conditions are poor, the opposite may apply. Reduced work opportunities for contractors and an increased ability to contain their wage costs in a slack labour market may result in a greater level of savings.

The studies listed in tables E.1 and E.2 cover the period from 1977 to 1995. As a result, the estimates of cost savings have been made over all parts of the business cycle. Most of the evidence suggests that there is not a correlation between the effect of contracting on costs and the stage of the business cycle.

One possible exception is the Walsh and Davis (1993) study of compulsory competitive tendering (CCT) at the local government level in Britain. Their average estimated savings across eight services increased between 1989 and 1992 as economic conditions worsened.¹⁸ This was particularly evident in building cleaning, where savings increased from 11 per cent to 16 per cent during the period. The authors attributed some of the increase to the weaker economic conditions, especially as a result of downward pressure on wages. They also noted that the larger savings could have been due, at least in part, to the increase in competition which emerged during that time.

The majority of evidence does not suggest that, for most services, cost savings vary to any significant degree with the general state of the economy.

Do any cost savings attributed to contracting result from other sources?

An issue that is difficult to assess is the influence factors other than contracting may have had on any cost savings reported in the literature.

In before and after studies, changes such as technological improvements in the way the service can be provided will affect costs. This is further complicated in before and after comparisons when an in-house team has won the contract. In this case it is difficult to disentangle the separate effects of contracting and

¹⁸ The estimated savings in 1989-90 were 5.8 per cent, in 1990-91 they were 7.1 per cent and the estimated savings for 1991-92 were 6.8 per cent.

changes in an agency, such as in the workplace culture, that often occur simultaneously with contracting.

Some studies have recognised the existence of other possible sources of cost savings. However, there is virtually no evidence on the relative influence of these alternative sources. For example, the Audit Commission (1995), in its review of local authority contracts in the UK, argued that, given the available data, it had not been possible to assign to particular causes the cost savings realised.

Further complicating any attempt to determine the true source(s) is the possibility that contracting and other changes in an agency are mutually reinforcing. That may produce greater cost savings than would otherwise occur.

While a proportion of the cost savings attributed to contracting in some studies may result from other sources, it is likely that contracting has been a major contributor to the savings. Studies of the effect of contracting on costs have been conducted in many countries, at various levels of government and across a large number of services. It is unlikely that other changes can explain all these instances of cost savings.

In practice, it is difficult to remove the presence of all other influences when estimating the effect of contracting on costs. There is a need to keep this in mind when interpreting the estimates of the cost changes. However, the prevalence of savings in most studies suggests contracting explains a significant proportion of these cost reductions.

Can the reported cost changes be generalised to all instances?

Although the estimated cost changes may be representative of the sample, they may not always be good predictors of the cost changes from future cases of contracting. It may be that the public agencies with the most to gain from contracting, in terms of cost savings, will be the first to contract services. Any cost savings achieved from doing so may not then be representative of the savings, if any, attainable by extending contracting to other agencies or services.

For instance, in Domberger, Meadowcroft and Thompson's studies on waste collection and hospital cleaning services, the number of agencies which had let contracts amounted to less than 10 per cent of the sample.¹⁹ Some doubt must exist whether the estimated cost savings could be obtained by all the other agencies in the sample.

¹⁹ For the waste collection study, the number was 50 out of a total sample of 610. The number of CTC observations for the hospital cleaning services study was 93 out of a sample of nearly 3000.

In addition, there may be an inherent tendency for studies to find cost savings. As Rimmer (1993) noted, depending on the incentives of participants, there may be an inclination not to divulge details of instances where such an exercise has failed. Alternatively, there may be some motive to downplay the success or exaggerate the lack of success of contracting. This problem is more likely in case studies and surveys where the questions are framed in a way which allows respondents to answer in a discretionary manner.

There are a number of reasons why the estimated cost changes reported in studies may not be applicable to cases which have not yet been contracted. Accordingly, it cannot be presumed that all the outcomes of future instances of contracting will necessarily replicate those already undertaken.

E.5 Sources of the reported cost savings

If the cost savings to the public agency reflect the better utilisation of resources, contracting can release resources for other uses in the economy, resulting in greater national output. On the other hand, if the cost savings result from a transfer between economic agents (such as reductions in wage payments for the same work) there may be little resource savings.²⁰

This section examines whether the ongoing cost savings from contracting reflect resource savings or transfers. The costs incurred during the transition to contracting are not discussed. Transition results in once-off costs such as the redeployment and training of staff and the reorganisation of the agency, as well as any redundancy costs associated with the move to contracting. Although transition costs must be considered in any overall assessment of the merits of moving from internal provision to contracting, the emphasis here is on the ongoing costs of service provision under internal provision and contracting.

There are a number of possible sources of the cost savings resulting from contracting.

Cost savings due to improvements in the productivity of labour and capital

Costs can be reduced by increasing the productivity of labour and capital, thereby reducing the number of employees and the quantity of capital required to produce the same service. There are a number of ways in which productivity may improve through contracting. For instance, work practices may improve,

²⁰ It should be noted, however, that if the wage payments are initially above that paid to similar labour in other industries, reducing the wage may still improve resource allocation and increase national output.

resulting in resources being used more efficiently in the provision of the service. Better planning, coordination and management of the service provision may also improve the productivity of labour and capital.

Cost savings due to less costly combinations of factors of production

Cost savings can also be realised if a less costly combination of inputs is used to provide the service. Again, there are several means by which this can be achieved. The initial combination of capital and labour employed may not be the most cost efficient. A change in the factor mix may enable the service to be provided at a lower cost. Alternatively, a new or different technology may be introduced by the contractor which allows the use of a less costly combination of capital and labour. Finally, better matching of labour and capital to the task may also result in cost savings.

Cost savings due to reductions in payments to capital and labour

A third source of cost savings is reductions in the payments to the factors of production. In many cases this will entail reductions in the payments to labour, which can occur in two ways. First, labour may receive reduced wages and/or conditions for doing the same amount of work as before. This is a straightforward transfer from the worker. Secondly, labour may receive the same wages and conditions in return for an increased work effort. As Quiggin (1994) noted, if the disutility incurred by workers for their greater work effort is not rewarded, their harder toil constitutes a transfer from workers to the taxpayers and/or consumers (if the service is being delivered at a lower cost), or otherwise, to the employer.

Cost savings due to cost-shifting

Another possible source of cost reductions is cost-shifting. This occurs when public agencies reap direct savings from contracting which are the result of shifting costs to other parts of government. Cost-shifting within government can occur in a number of ways.

One possibility is cost-shifting through the taxation system. The cost savings may reflect the increased ability of those delivering a service to evade their taxation liabilities. This would impose additional costs on other parts of government from reduced taxation revenue and/or increased enforcement and collection costs. A second possibility is that cost savings reflect a reduction in the number of people employed in the provision of the service; in turn, this may impose an additional financial burden on the central government if it increases the amount of unemployment benefits (and other associated costs) and reduces its taxation revenue. A third possibility exists if differential funding

arrangements, such as those applying to public and private health care, allow State governments to increase the cost burden on the Commonwealth Government through contracting. If these or other instances of cost-shifting do exist, any estimated cost savings from contracting will tend to exaggerate their true extent.

Empirical evidence

The empirical evidence on the sources of any cost savings is mainly based on general observations and anecdotal material. Very few studies have attempted to identify the probable sources and then quantify their effects.

One study specifically designed to gauge the proportion of any cost savings attributable to improved resource utilisation was undertaken by Cubbin, Domberger and Meadowcroft (1987).²¹ Using linear programming techniques they found that, of the estimated 22 per cent cost savings achieved by using external contractors, approximately three-quarters (ie 17 percentage points) could be attributed to the improved productivity of labour and capital. They identified two probable causes of these efficiency gains — the better matching of labour and capital inputs to the task requirements and changes in the incentives which encouraged workers to increase their productivity. The estimated contribution of improved productivity in the savings achieved by successful in-house tenderers was much lower, with only two-fifths of the 17 per cent savings (ie 7 percentage points) being attributed to efficiency gains.

Szymanski and Wilkins (1993) estimated the change in the numbers of employees required to collect each unit of waste after contracting. Their results have to be viewed with caution as they varied depending upon the empirical model estimated.²² However, using pooled data, the number of employees per unit was estimated to be 25 per cent lower for private contractors than for councils which did not hold a competitive tender. In-house teams which won tenders were estimated to use 19 per cent fewer employees per unit. The authors noted that, while these outcomes indicated that the associated estimated cost savings were primarily the result of productivity improvements, it might have been that the cost savings were achieved through a reduction in the effective hourly wage rate of those remaining employees who may have had to work longer hours for no extra remuneration.

²¹ Cubbin, Domberger and Meadowcroft (1987) used the data and estimated cost savings from the Domberger, Meadowcroft and Thompson (1986) study of waste collection.

²² Szymanski and Wilkins (1993) used three alternative data approaches in estimating costs per unit of waste, costs per employee and employees per unit of waste. They were cross-sections by year, pooled data and panel data.

The studies also convey a reasonable amount of observational and anecdotal evidence. Several studies have found that the most significant source of cost savings from contracting was a reduction in the total payments to labour.²³ A number of reasons for lower labour costs have been presented.

Some studies argued that savings are attributable to both productivity gains and the use of a less costly factor mix. Stevens (1984) contended that the lower costs from contracting flowed from improved management practices and the change in technology used. McDavid (1985) pointed to the existence of productivity incentives for workers. Mehay and Gonzalez (1985) maintained that the competitive process constrained overstaffing.

The study into CCT among local authorities in Britain by Walsh (1991a) and the subsequent research by Walsh and Davis (1993) reported that productivity improvements were considered to be the main source of any cost reductions. Reductions in employment were a more important contributor to lower costs than were reduced pay and conditions. One of the primary reasons given for the increased productivity was the extensive review of work practices that the CCT process had initiated.

The adoption of more capital-intensive production methods has been identified as a source of cost savings in some studies. McDavid (1985) observed that waste collection contractors tended to use larger capacity vehicles operating with smaller crews. Hall and Domberger (1995) noted that the contracting of cleaning services had resulted in the use of more sophisticated equipment at the same time as the labour input was reduced. In these cases cost savings were achieved by the use of a lower cost combination of inputs.

There is some evidence that contractors have been able to reduce their labour costs by using more flexible employment policies. Contractors appeared to make more use of part-time employees, allowing increased flexibility in their staffing levels. This may have also enabled contractors lawfully to pay lower wages and lessen the conditions of workers if reduced remuneration can be paid from that applying to public sector employees (Rimmer 1993). Contractors may also be able to change the composition of their workforce to one which, while retaining the same labour input, costs less. This may be the result of a better capability to target labour requirements to the task. Stevens (1984) noted:

Contractors tend to use part-time labor wherever possible. Part-time labor does not accrue the more expensive fringe benefits (eg retirement benefits) that are available to full-time employees. Also, contractors are very likely to use the least qualified personnel capable of doing the job. (Stevens 1984, p. 402)

²³ See, for instance Pack (1989), Walsh (1991a) and Hall and Domberger (1995).

Stevens added that the use of such labour possibly reduced costs at the expense of the capacity to respond to any additional tasks that may arise unexpectedly.

There is also evidence to suggest reductions in the wages and conditions of employees is sometimes an important source of cost savings. In one instance, it was found that the wage–fringe benefit mix paid to workers after contracting changed markedly — while wages increased, fringe benefits were reduced significantly (Berenyi 1981). Hartley and Huby (1986) claimed that more than 50 per cent of the contractors in their survey paid lower wage rates than internal service providers. Pack (1989) calculated that, in approximately half of the cases analysed, the cost savings were achieved through reduced wages and conditions. Cost savings in the other half were achieved through cuts in the labour force.

The evidence on the existence of cost-shifting is limited. It has been suggested that the evasion of taxes is an uncommon practice among public sector employees by comparison with those in the small business sector. Workers in this sector often work non-standard hours that enable a greater opportunity for evasion practices (Quiggin 1994). Piecemeal work and cash payments provide an incentive for workers to understate their incomes. This potential to evade tax may be built into their wage payments. Accordingly, what appears to be a legitimate cost saving from contracting may simply reflect the greater opportunity of some private sector workers to evade their legal taxation responsibilities.

However, as noted by Quiggin, measures introduced by the Commonwealth Government during the past decade have made tax evasion more difficult for employees. As a result, it is likely that any cost savings from contracting will not contain any significant component which reflects workers' ability to evade their taxation responsibilities.

Cost-shifting may also take place if contracting causes a net reduction in jobs. In its analysis of the costs and savings of CCT in the United Kingdom, the Centre for Public Services (1995) calculated that the indirect costs of CCT to the central government were double the direct savings achieved by local government. This estimate was based on an analysis of the cost and employment effects of CCT on four services — building cleaning, education catering, refuse collection and sports and leisure management.²⁴ While the direct savings to local authorities providing these services were estimated to total 124 million

²⁴ The initial focus of the study of these four services was the examination of the impact of CCT on women's employment and wages relative to those of men. The information collected from interviews, questionnaires and discussion groups during the course of this study enabled the supplementary analysis on the cost-shifting impact of CCT to be conducted.

pounds, the indirect costs to the central government as a result were estimated to amount to 250 million pounds — a net cost of 126 million pounds.

The costs to the central government were assumed to come from both increased outlays and reduced revenues arising from the additional unemployment occurring in the aftermath of the introduction of CCT. Among the additional outlays considered likely were increases in the number of recipients of unemployment benefits and other social welfare entitlements, redundancy payments, increases in labour program expenses and higher health care costs. Related administration costs were also likely to increase. Lower revenue would result from reduced taxation income due to the fall in employment. This reduction was expected to come from various sources including reductions in income tax revenues, national insurance contributions, value added tax and other indirect tax collections.

This methodology captures the potential immediate impact of contracting in instances where job reductions occur. However, any investigation of cost-shifting associated with contracting must be sure to incorporate all the additional costs and benefits. For example, contracting may increase net unemployment in the short term if any public sector employees are made redundant and are not employed by contractors or elsewhere. But, over time, the reduction in the costs of services from contracting may create other jobs. To make a complete assessment of the cost-shifting argument presented by the Centre for Public Services (1995), account must be taken not only of the first round effects of the change, but of all subsequent effects.

The available evidence on the sources of the cost savings from contracting is mixed. It appears that the cost savings may be due to a combination of productivity improvements, the use of better combinations of the factors of production, and transfers (mainly from labour). The importance of each of these sources to the overall cost savings appears to vary from case to case.

E.6 Conclusion

From the evidence presented in this appendix some tentative conclusions can be reached on the effect of contracting on the costs to public agencies of providing services. In doing so, the caveats discussed throughout the appendix need to be kept in mind.

It would appear that, in the majority of instances, contracting reduces the ongoing costs to public agencies. However, the evidence indicates that the extent of any ongoing cost savings is highly variable. There is no automatic level of savings that can be attained by contracting.

The exclusion of certain types of costs associated with contracting, particularly transition costs, indicate that the true extent of any cost savings may have been overestimated by many of the studies included in this review. Despite this shortcoming, it seems most unlikely that these costs are large enough to change the finding that cost savings generally do occur as a result of CTC. Further research would do well to take fuller account of the effect of transition and transaction costs on the size of cost savings.

There are a number of possible sources of any cost savings from contracting. The most prominent appears to be reductions in labour costs. This can occur from increases in labour productivity and/or reductions in the wages and/or conditions of workers. The relative importance of these (and other possible sources discussed above) varies from case to case. However, it would appear that in many cases increased labour productivity is the major source.

Attachment E1 Identifying and measuring the costs of internal provision and contracting

When comparing the costs of service provision under internal provision and contracting, it is important to include and correctly measure all relevant costs. The aim of this attachment is to identify the costs to the government agency of service delivery under internal provision and contracting and broadly discuss how they should be measured.

Some costs may not be apparent and therefore not included. Other costs may be included, but not be relevant. Both errors can distort cost comparisons. At the same time, some costs may be difficult to measure, such as the costs of capital or overheads. Failing to measure these costs correctly may also lead to inaccurate cost comparisons.

Other costs may be uncertain or unknown. These could include costs associated with an unscheduled termination of the service; exceeding budget allocations; or any other unforeseen liability for which the government agency becomes responsible.

In many instances it is feasible to assign probabilities to each uncertain 'state of the world' which can then be used to estimate expected or likely costs. Although the assigning of probabilities often involves the use of subjective judgment, it is preferable to simply ignoring the existence of these costs. They can, however, be omitted from a cost comparison if one alternative is less costly even in the event that the uncertain costs attached to the preferred option are realised (Sugden and Williams 1990). While risk assessment is not discussed further in this attachment, attention is drawn to the possible existence and potential implications of uncertain costs.

In this attachment, a framework is developed for the identification and comparison of the costs of internal provision and contracting to the government agency responsible for the service delivery. This framework is designed to assist the assessment of the change in costs resulting from a proposed move from internal provision to contracting. This includes the costs incurred by public agencies in the implementational stage of contracting, as well as the expected ongoing costs. Although the list of relevant costs is not exhaustive, the discussion aims to provide a basic structure which allows all costs to be correctly identified.

As the emphasis in this attachment is on raising awareness of the relevant costs and the methods of measuring them, a full cost approach has been adopted in compiling the costs of internal provision and contracting. This includes all the costs normally incurred in delivering the service by either means.

Another approach is to list the avoidable costs, that is, the costs the government agency would avoid by the use of the alternative means of service delivery. In comparing the relative merits of internal provision and contracting from a cost perspective, it is the avoidable costs which are of primary interest. But, a difficulty arises in attempting to identify only the avoidable costs when a certain cost occurs for both internal provision and contracting but in different magnitudes, thus representing a net cost to the alternative for which it is greater. Using a full cost approach enables this problem to be overcome. Nevertheless, the practitioner need not measure those costs which can reasonably be expected to remain unchanged.

It should be stressed that this framework is not designed to guide public agencies when comparing in-house tender bids with those of private contractors. Nevertheless, the issues raised are also important for these comparisons.

Furthermore, the framework seeks to provide a guide to the relevant costs and methods of measurement *where the appropriate information is readily available*. Acquiring all of this data may be a very costly exercise and one which potentially negates the benefits of a more accurate cost comparison. The use of cheaper, albeit less precise, information is often more practical in these cases.²⁵

It should be noted that any cost savings estimated using this framework do not necessarily represent savings of resources. First, many of the costs may be transfers (eg reductions in wages and the return to capital) and hence, do not reflect reductions in the use of resources. Second, the costs considered are those incurred by the public agency directly responsible for the service provision. Costs which may be imposed on other sections of government, such as those resulting from some form of cost-shifting, are not discussed. In addition, costs to individuals, such as time spent unemployed, are not included.

This attachment does not discuss competitive neutrality issues, such as the question of how to treat any taxation advantages which government agencies may have over contractors. Chapter C5 contains an appraisal of this, and other competitive neutrality issues.

²⁵ Publications such as 'Guidelines for Costing of Government Activities', (Department of Finance 1991) provide methods and formulas for estimating costs based on available information.

Costs of internal provision

All of the costs of internal provision described here occur on an ongoing or recurrent basis and can usually be measured on an annual basis. The broad cost categories are:

- labour costs;
- operating and maintenance costs;
- capital costs;
- administrative costs; and
- management and monitoring costs.

Labour costs

Gross wages and salaries need to be measured, both of staff directly employed in providing the service and that proportion of wages and salaries of support staff which can be attributed to the service provision. Even if these support staff perform other duties, this estimate represents the opportunity cost of their time allocated to the service.²⁶ Allowances, such as higher duties payments or meal allowances, must also be included.

Other labour costs, including overtime payments, employer superannuation and workers compensation contributions²⁷, shift/penalty payments, leave loadings and any other salary-related expenditure should also be included. This also applies to the costs associated with task-specific training and any general training costs which can be apportioned to the provision of the service.

Operating and maintenance costs

The costs of energy and materials used in providing the service should be included. Apart from the direct costs of the inputs consumed, expenses associated with warehousing, delivery, handling, invoicing, ordering and insurance should also be included.

²⁶ This may include, for example, personnel and information technology support staff. If the labour costs of these support services cannot be readily calculated then an estimate may be used. One possibility is to apportion the cost of the supporting staff according to the relative size of the services to which they provide the support (eg if support is provided to garbage collection and building inspection only, the cost of the support could be fully allocated to these services in line with their relative labour costs).

²⁷ Apart from the compensation contributions, allowance may also have to be made for any residual costs associated with compensation claims, such as legal costs.

In addition, any maintenance and repair costs incurred in providing the service need to be included. Although these costs normally arise from the servicing of equipment and buildings, they are variable in nature and should be separated from capital costs.

Capital costs

The ownership and use of capital goods usually imposes two types of costs. First, there are the costs incurred in the consumption of capital. Second, there is the opportunity cost of the funds in capital ownership.

There are a number of methods by which the annualised costs of capital can be calculated. The decision on what method to use will depend on the amount of information available and the required precision of the estimated cost.²⁸ Where possible and desirable, an annual user charge should be calculated. This is an estimate of the full cost per year to the owner of utilising the capital over its economic life.²⁹

Where a unit of capital can be traded freely, its replacement cost should equal its disposal value, or value on the market (assuming disposal costs are negligible). In this case, the annual cost of owning the unit of capital can be measured by the change in the replacement cost during the year and the opportunity cost of the funds equal to the disposal value at the start of the period.³⁰

Calculating the costs of equipment or buildings which are leased is simpler. The lease payments comprise the capital costs to the public agency in this instance.

Administrative costs

Administrative costs, in general, can be divided into two categories. The first category includes those costs which can be attributed solely to the service

²⁸ In many instances, using the appropriate rates of capital depreciation and return on funds may be sufficient. This information is normally readily available to public agencies. For a discussion on the appropriate depreciation rates and rates of return to use when calculating capital costs, see Department of Finance 1991.

²⁹ For an analysis of annual user charges and the methods of calculating asset values, see Salerian and Jomini 1994.

³⁰ If the disposal value differs from the replacement cost, care needs to be taken in determining the annual cost of capital. If a capital asset is not suitable for any alternative use, or other means of utilising the asset are not available (ie the asset is a sunk cost), the disposal value may be negligible. For example, machinery may have no other productive purpose, or building space occupied in delivering the service may not have any alternative tenants.

provision in question. The second contains those administrative costs which are likely to be joint costs incurred with other activities.

Costs incurred entirely in the service provision may include such items as travel, post and telephone expenses. Other administrative costs, such as office furniture and computer services will often be attributable to more than one activity. The proportion of these costs which should be included in the cost of provision may be calculated in a similar fashion to the attributable labour costs of support services (see above).

Management and monitoring costs

The costs associated with the executive management of a service are often difficult to identify. The devotion of time and energy by staff in managing a service imposes a cost, as their efforts could have been put to an alternative productive use. As a result, a measure of the management value foregone should be included. The proportion of time devoted to the task multiplied by the cost of management staff will approximate the cost. These costs are often overlooked in cases where the change in the manner in which a service is provided does not diminish the amount of management staff employed by a public agency.

Monitoring of service provision is required to ensure an adequate performance level. Although a portion of monitoring costs will be captured in the attributable management costs, some component may escape direct notice. These costs may include items such as the use of vehicles to visit work sites or consultants' expenses.

Costs of contracting

Not all of the costs to a public agency attributable to contracting are of an ongoing nature. Some may occur at a specific stage, usually prior to the commencement of the service provision. Accordingly, careful consideration is needed when incorporating these costs in the calculation of the overall costs to a public agency of contracting. Both ongoing costs and other costs associated with contracting must be considered when making a decision on the relative merits of internal provision and contracting.

Included among the costs of contracting are:

- the contract price;
- out-turn costs (or savings);
- government furnished equipment and material costs;
- management and monitoring costs;
- tendering and contract costs; and

- transition costs.

The first four cost types can usually be considered ongoing costs, although contractors may be paid under some arrangement other than periodic payments. The tendering and contracting costs can be viewed as transaction costs and are normally incurred prior to the commencement of the contract. These up-front costs must be made comparable with the ongoing costs. The transition costs, such as redundancy payments, are once-off costs incurred in the change from internal provision to contracting. Because of their nature, the manner in which they should enter the overall cost comparison differs from other cost types.

The contract price

This is usually the largest component of the cost of contracting to a public agency. If payment is not made on a periodic basis it will be necessary for an adjustment to be made for comparative purposes. For example, if the full payment is made at the beginning of the contract period it should be converted to an equivalent annual cost over the life of the contract.

Out-turn costs or savings

The initial contract price may subsequently be adjusted as a result of the agreement of the public sector agency and the contractor. Out-turn costs may be positive, that is, an additional cost of the service provision, or negative where any cost reduction below the contract price is shared between the agency and the contractor.³¹

Government furnished equipment and materials

In some instances the government agency will supply the service provider, whether it is an in-house team or an external contractor, with equipment and/or materials. The supply of this equipment and materials should be included in the costs of contracting. These costs will often be identical to those which would be incurred if the equipment and materials were being used by the agency to provide the service directly.

Management and monitoring costs

Service provision under contract will require contract management. Any cost incurred should be included in the costs of contracting.

There are also costs incurred in monitoring the service delivery by a contractor. These costs may be more transparent than for internal provision because of the

³¹ This could possibly occur as a result of a technological advance which becomes accessible to the contractor during the contract period.

clearer distinction between the management and monitoring roles of a government agency when contracting occurs. Where service performance is deemed unsatisfactory there may also be additional costs incurred in ensuring contractor compliance with the contract specifications.

Tendering and contract costs

Prior to a service being contracted, costs are incurred by the public sector in organising the tender process (if a competitive tendering process is undertaken) and detailing the contract specifications. These include the costs of staff and resources devoted to these tasks, as well as the financial costs of any external expertise that may be required.

Costs are also incurred by prospective contractors in assessing the viability of tendering for the contract and determining the composition of their bid. The tendering costs of external tenderers need not explicitly be taken into account by a public agency when assessing the cost-effectiveness of contracting. Nevertheless, as firms offering tenders will endeavour to recover the cost of tendering, some portion of this cost is likely to be incorporated into the cost of the successful bid.³²

However, the costs incurred by in-house teams when tendering for contracts do need to be considered. The time spent by agency staff on preparing a tender bid entails an opportunity cost. The cost of any additional resources or consultants used should also be included.

Costs specific to the tendering and contract process are usually incurred before the service is provided by the contractor. To make these costs comparable to the annual ongoing costs, they should be allocated over the life of the contract. This can be achieved by converting these costs to an appropriate annuity with a Present Value equal to these costs.

³² Under certain circumstances, the total costs incurred by all tenderers in tendering for the contract may be covered by a component of the successful bid price. This assumes that the tendering firms are relatively homogeneous, are competing in a particular market and have equal probabilities of winning contracts (IC 1994b). For example, if five firms are bidding for ten similar contracts and each firm determines that it has a 0.2 probability of winning any one contract (that is, each expects to win two contracts) it is likely each firm will add half of its total tendering costs to each of its tender prices. If each firm wins two of the contracts, the total tendering costs will be reflected in the total contract prices and if the ten contracts are of approximately equal value, each contract price will contain a component which accurately reflects the total tendering costs by firms for that particular contract.

Transition costs

The move from internal provision to contracting involves a substantial change in the way the service is provided. As a result there can be a wide range of transition costs incurred by the public agency. These include the internal reorganisation of the agency which may involve the redeployment or redundancy of staff. The agency may also need to train staff so they can effectively manage the contracting process and the contract itself.

It is important to note that transition costs are incurred in the move from internal provision to contracting, rather than through the acceptance of a particular bid. However, if this move is to reduce the costs to the public agency of service provision, any savings (when taking into account ongoing and transaction costs) must outweigh the costs of transition.

As any cost savings are reaped in the future and the transition costs usually occur prior to contracting, they are not directly comparable. Comparability can be achieved by converting the transition cost to an annuity.³³ The dilemma arises as to the appropriate period of time over which to spread the transition costs. This should be determined by the period over which any cost savings from contracting are expected to be reaped. Any savings further than ten years hence are likely to have a negligible Present Value. This may be especially so if the discount rate is loaded with a premium to reflect the presence of uncertainty arising from factors like technological progress which might change the way the service is provided and the subsequent cost saving. As such, it may be prudent to convert redundancy costs into an annuity over a maximum period of ten years.³⁴

³³ Comparing an up-front cost with any savings realised in the future by converting the up-front cost to an equivalent annual cost is only strictly applicable if the future savings do not vary from one period to another. If the future savings are not likely to be constant, their Present Value should be calculated and compared with the up-front cost.

³⁴ The UK Treasury argues that the correct period over which to appraise redundancy costs will range between five and ten years. The precise period will vary according to the commercial context of the operation and the level of certainty surrounding the continuity of cost savings (Citizen's Charter 1991).

APPENDIX F COST CASE STUDY – AMBERLEY RAAF BASE

F.1 Introduction

This appendix examines the effect of competitive tendering and contracting (CTC) on the costs of several aircraft maintenance and repair activities at Amberley RAAF Base. The aims of this case study are to measure as accurately as possible the change in costs to the RAAF and the Department of Defence resulting from CTC and to identify the sources of any cost changes. The Commission thanks the Department, the Commercial Support Program (CSP) team and staff at Amberley RAAF Base for their co-operation.

F.2 Background

In the Wrigley report entitled *The Defence Force and the Community – A Partnership in Australian Defence* (Department of Defence 1990), it was suggested that a range of support activities in the Australian Defence Force could be performed more efficiently and cost-effectively by civilians. Subsequently, it was decided that a number of activities be tested for the cost-effectiveness of commercial support from industry, including several of the repair and maintenance operations undertaken at Amberley RAAF Base. This was conducted as part of the CSP instituted by the Department of Defence.

In February 1992, the No. 3 Aircraft Depot and 482 Squadron at Amberley RAAF Base were amalgamated, resulting in the formation of 501 Wing. This organisation of 1126 personnel, nearly all of whom were military personnel, performed Deeper Level maintenance, primarily on the RAAF's F-111 fleet.¹ Deeper Level maintenance involves a range of activities including the scheduled and unscheduled repair and maintenance of aircraft and avionics systems and engines, and electroplating, carpentry and machine shop services to support major aircraft maintenance and engine overhaul. 501 Wing also provides specific technical training for personnel working on F-111 aircraft.

Under the CSP, a number of activities performed by 501 Wing were tested, commencing in July 1992. Among these was the repair and overhaul of the TF30 gas turbine engines. This activity involved 162 of the 356 personnel

¹ Deeper Level maintenance is the combination of what had previously been known as Depot Level maintenance and Intermediate Level maintenance. Operational Level maintenance is the other maintenance level and is not undertaken by 501 Wing.

employed in the seven activities tested. Several private sector firms tendered for some of the activities specified in the Statements of Requirement (SOR). At the same time, an In-House Option (IHO) was mounted by 501 Wing covering all of the identified activities. In November 1993, the decision was announced that the IHO had been successful. The cost advantage of the IHO over private contractors was one of the major criteria on which the decision was based.

F.3 Estimated cost savings

The Commission has estimated the cost savings from the competitive tendering to be nearly \$8 million a year. This may underestimate the real savings, as the scale of work carried out within the specifications of the SOR has increased from that performed previously. At the same time, the level of performance has probably improved. Although individual examples of delays still occur, the time needed to carry out maintenance and repair tasks has been reduced in many instances.

The workload undertaken by the IHO has also been augmented since the success of its bid. For example, the procurement of several F-111G aircraft by the RAAF (to complement the existing F-111C fleet) has further increased the maintenance and repair responsibilities. This has required extra personnel. The costs associated with this additional work have been excluded from the analysis to allow for a more direct comparison with the pre-existing workload.

Table F.1 indicates that virtually all the estimated savings arise from reduced personnel and related costs. These costs have been reduced by almost \$9.5 million a year.² The estimated total annual savings are \$1.5 million less than this amount because of the costs associated with competitively tendering the F-111 Deeper Maintenance activities in the CSP. These costs include those incurred by the RAAF in the tender preparation and evaluation process, in implementing the IHO, and in managing the work directive.³

² The actual overtime payments to APS personnel in 1994-95 were approximately \$200 000 less than budgeted as a result of the delay in achieving the military/civilian personnel mix proposed by the IHO. This meant that RAAF personnel were performing duties earmarked for APS staff. In the future, as the proportion of civilians increases, overtime costs will probably rise. Future overtime costs will also depend upon the workload of the IHO.

³ Due to the in-house status of the successful tenderer, the agreement between the RAAF and the IHO is described as a work directive rather than a contract.

Table F.1: Cost comparison between the pre-existing and In-House Option provision of F-111 Deeper Maintenance at RAAF Base Amberley

<i>Type of cost</i>	<i>Pre-existing costs (\$)</i>	<i>In-House Option costs (\$)</i>
<i>On-going (annual) costs</i>		
Personnel and related costs ^a	20 131 276	10 706 751 ^b
Other variable costs	750 000 ^c	741 976 ^d
CSP management costs	-	120 000 ^e
Total on-going costs	20 881 276	11 568 727
<i>Transaction costs</i>		
Tender preparation costs	-	114 716
Tender evaluation costs	-	117 553
IHO tendering costs	-	879 475
Total transaction costs	-	1 111 744
Annualised transaction costs^f	-	278 444
<i>Transition costs</i>		
Redundancy payments ^g	-	4 305 300
Facility refittings	-	797 323
Equipment purchases	-	850 676
Other implementation costs ^h	-	1 470 821
Total transition costs	-	7 424 120
Annualised transition costsⁱ	-	1 106 410
Total annual costs	20 881 276	12 953 581

a Derived from Ed. 3 (CSP Version), Ready Reckoner of Personnel Costs and Related Overheads (Department of Defence 1994).

b This consists of the costs of the 214 personnel as projected in the IHO and the actual overtime costs.

c No directly comparable amount for other variable costs of the pre-existing provision was available, due to changes in the items now purchased directly by 501 Wing (as opposed to those requisitioned from central supplies). These costs were assumed to be marginally larger than for the IHO.

d This is the actual 1994-95 amount for other variable costs. It will overstate the cost of performing the tasks previously undertaken due to the increase in the workload performed by the IHO.

e This is the average annual cost of monitoring and supervising a contract in the CSP. These costs can vary widely, but do not necessarily bear any relationship to the contract value.

f Transaction costs have been converted into an annuity over five years (the initial work directive period) using a real discount rate of 8 per cent.

g No breakdown was available of any accrued leave payable in the redundancy payments. Hence, this amount overestimates the true cost of the 113 redundancies. However, further redundancies would have been necessary if the IHO had not subsequently taken on additional tasks.

h Includes consultancy fees and additional personnel costs incurred during the implementational stage.

i Transition costs have been converted into an annuity over 10 years using a real discount rate of 8 per cent.

Source: Commission estimates based on information supplied by the RAAF

The tender preparation and evaluation costs (termed the transaction costs) have been included in the calculations as an annuity over five years. This reflects the period of the work directive (although there is a further six year option). The costs incurred in implementing the IHO (termed the transition costs), such as redundancy payments made to personnel excess to the bid, have been converted into an annuity over 10 years. These are once-off costs which will not be incurred again. As a result, they have been spread over a longer time period than the transaction costs.⁴

The analysis shown in table F.1 only includes those costs which have altered or occurred as a consequence of the move from the pre-existing provision to the IHO. For the purpose of identifying the change in costs resulting from provision by the IHO, there was no need to calculate the size of any costs which could reasonably be expected to have remained the same before and after the changeover. The exclusion of these costs from the analysis makes it inappropriate to represent the estimated cost savings associated with the IHO in a percentage form.

Capital costs are among those costs considered to have remained unaltered. There has been a reduction in the building workspace used by the IHO as a result of reorganisation of the work processes. Some of this excess workspace consists of purpose-built facilities with few alternative productive uses. Moreover, the option of commercial utilisation is precluded for security reasons. Nevertheless, some general facilities have been put to alternative use. While this constitutes a cost saving, it may be small and difficult to quantify.

The personnel and related costs are derived from Edition 3 of the CSP Manual's Ready Reckoner tables (Department of Defence 1994). These tables calculate the cost of employing each military and civilian member of personnel. The tables account for different rankings and locations. They encompass both direct and indirect labour-associated costs, including salary, allowances, superannuation payments and activity and management overheads.

It should be stressed that these are average costs per employee. There will, in practice, be some variation within each identified ranking to allow for differences in experience and skill level. As a result, the estimated personnel and related costs presented in table F.1 should be viewed as indicative only. They are also assumed to cover the typical management and monitoring costs incurred by both the pre-existing and IHO provision. These costs are incorporated in the activity and management overheads attributable to each staff member. The additional CSP management costs associated with the IHO relate

⁴ For a further discussion of the appropriate treatment of transaction and transition costs, see attachment E1 of appendix E.

to the estimated average cost of monitoring and supervising each contract (or work directive) in the CSP.

F.4 Sources of cost savings

As shown in table F.1, the IHO was able to achieve significant cost savings through reductions in personnel and related costs. These cost savings were essentially derived from two sources — productivity improvements and a decrease in the ratio of military to civilian staff.

The major savings have resulted from the reduction of personnel from 356 to 214. The Commission has estimated that the reduction in personnel numbers accounts for approximately 80 per cent of the reduced personnel and related costs. The means by which these productivity improvements were achieved are discussed in the next section.

The remainder of the savings resulted from increasing the proportion of civilian personnel. Of the reduced workforce of 214 now needed to perform the work, 128 are RAAF personnel and 86 are civilians. This compares with a base of 343 RAAF personnel, 10 Australian Public Service (APS) personnel and 3 Supplier Field Maintenance staff (ie 13 civilians). The CSP Manual's Ready Reckoner indicates that the full cost to Defence of employing a civilian is approximately 30 to 40 per cent less than that of employing a member of the RAAF of comparable skill (Department of Defence 1994).⁵ The personnel changes were achieved through a combination of redeploying RAAF personnel, their civilianisation using Section 81B of the *Public Service Act*, redundancies and the recruitment of additional civilian staff.⁶

F.5 Sources of productivity improvements

Providing the same service with a reduction in personnel required improved labour productivity. The productivity improvements discussed below were, in part, made possible through improvements in business practices and changes in the workplace culture prior to the IHO mounting a bid. These changes followed

⁵ The difference in total costs will vary in individual instances and depends, among other things, on the type of work performed. The inclusion of overtime payments for APS personnel in a comparison will reduce the cost differential.

⁶ Of the RAAF personnel who were excess to the IHO, 50 were redeployed within the RAAF, 44 transferred to APS positions created in the IHO and 113 accepted redundancy packages. Other personnel who were originally excess to the IHO were retained when its workload was subsequently augmented. The administrative costs of these actions are not included in the calculation.

the introduction of a number of programs designed to improve management and production practices through better tracking of resources, improved production flows and greater focus on customer needs. The investment made in personnel to improve their outlook and encourage them to take more responsibility for outcomes changed the workplace culture. As a result, attitudes had altered in 501 Wing even before the decision to test activities under the CSP was made.

Nevertheless, a number of specific changes were made by the IHO to further improve productivity. This involved major alterations in organisational and production structures. The more important changes are listed below.

1. Re-engineering of workshops

Following extensive consultation with the workforce and the Australian Manufacturing Workers' Union, workshops were re-designed to allow a more continuous flow of the work from one stage to the next. This increased communication and improved internal scheduling between work teams. These advances reduced production flow problems, enabling maintenance and repair tasks to be completed in less time.

2. Cellular work teams

Cellular work teams of 15 to 25 people were set up for different tasks. Each team is headed by a team leader and a team coordinator. Team members have been encouraged to propose methods by which the team can improve its performance and identify potential problem areas. This concept increased ownership at the team level, improving the incentives for its members to become accountable for team performance. The introduction of the cellular work teams has provided staff with the opportunity to contribute worthwhile ideas on ways of improving work processes.

3. Changes in the management structure

In conjunction with cellular work teams, the number of management levels has been reduced from eight to four. In addition to removing unnecessary personnel, the flatter management structure has facilitated communications between management and production level personnel. This has assisted in the management and allocation of resources and the forecast of workloads, further improving productivity.

4. Process improvements

Several changes to the production process have been implemented. The non-essential independent inspection at the workshop level has been removed. This inspection was judged to be unnecessary as a result of the change in work

practices which has allowed greater participation and responsibility for quality control.

Multi-skilling has enabled an improved flow in the production process, with personnel being able to be more productively employed. On the other hand, there has been a recognition of the need to have staff undertaking tasks commensurate with their skill levels. That is, there is now an improved division of labour. For instance, technicians no longer sweep up around their benches and worksites; a cleaner performs this task instead.

Another change which has sped up the turnover time in repairing and maintaining the F-111 components has been the move to a Make to Stock inventory system. This has enabled teams to access components when they are required to replace those that are damaged, rather than having to repair or remake them. While this may, in some cases, impose some additional cost in having components sitting in stock for a length of time, this has been more than offset by the increased speed with which teams can complete tasks. For example, the full strip-down and maintenance of the TF30 engines has been reduced from approximately 150 days to less than 100 days, with further improvements in turn-around time anticipated.

5. Financial modelling and benchmarking

To improve workshop resourcing, a costing model has been implemented that allows managers and team leaders to better assess the full cost of their activities and compare these costs against benchmarks. This has made more apparent the cost of additional capacity and ineffective planning.

F.6 Possible problems resulting from the changes

The Commission has been made aware of some concerns resulting from the inclusion of the activities in the CSP and the subsequent awarding of the work directive to the IHO.

During the period of uncertainty prior to the decision in favour of the IHO, a number of personnel with skills particularly useful to the RAAF accepted redundancy packages. This loss of skills has had some impact on the capabilities of the IHO and these staff have proved somewhat difficult to replace. Defence considers that this problem should be rectified over time.

A concern of a more permanent nature is the IHO's ability to cope with unexpected surges in its workload. The teams are currently operating with limited excess capacity and sudden increases in their workloads may be difficult to cope with. The RAAF readily admits that, prior to the work being tendered,

these areas operated with considerable excess capacity. While this has been shown to be an inefficient way in which to operate, it had the advantage of providing the capacity to cater for workload surges. The IHO does not have this luxury and the extent to which it can cope with these surges within its allocated budget is yet to be fully tested. However, the RAAF considers that the recent workload has been the equal of any peak that may eventuate in the future and this has been accommodated satisfactorily.

F.7 Conclusion

Despite the concerns expressed above, the inclusion of the F-111 Deeper Maintenance activities in the CSP has allowed considerable cost savings to be achieved. Exposing the activities to competition provided 501 Wing with the opportunity and the incentive to seek more cost-effective means of undertaking the tasks.

While some of the estimated \$8 million annual cost savings have been achieved by altering the mix of personnel, the major source of savings has arisen from productivity improvements.

APPENDIX G QUANTIFYING THE ECONOMY-WIDE IMPACTS OF CTC

This appendix presents the results of a modelling exercise estimating the possible economy-wide impacts of competitive tendering and contracting (CTC). As many aspects of CTC are subject to a high degree of uncertainty, the aim of this exercise is to quantify a range of possible effects of CTC. Alternative assumptions are made regarding the further use of CTC by all levels of government throughout Australia; the cost reductions possible from CTC; and the mix of productivity improvements and reductions in wages and conditions in achieving the cost reductions. As a result, eight different scenarios are considered, giving a range of the possible economy-wide effects. While the Commission regards the assumptions used in the modelling exercise as conservative, it cautions that modelling does not manufacture certainty out of the unknown.

Across the different scenarios the annual economy-wide gains from CTC are estimated to be in the range of 0.3 to 1.7 per cent of GDP (\$1.3b to \$7.3b in 1993-94 dollars), with real wages increasing by between 0.2 and 1.3 per cent. Adjustment costs may be incurred in achieving these economy-wide gains. For example, just among those jobs subject to CTC, it is estimated that there may be a reduction in full-time equivalent jobs of between 12 500 and 74 700. Increases in employment in other industries, however, result in a marginal overall increase in employment of between 500 and 4 400 full-time equivalent jobs.

The aim of this appendix is to examine the likely industry and economy-wide impacts of competitive tendering and contracting (CTC). This is achieved by incorporating a range of estimates of the direct impacts of CTC on expenditure in the public sector into a general equilibrium model. The results of the modelling exercise are not intended to be definitive. They do, however, indicate the broad economy-wide effects of CTC through the effects on prices and production capabilities — holding other economic variables and social objectives constant.¹

¹ The results, therefore, represent only a conditional and not an actual forecast of changes in the economy. This method is used as it isolates the impact of CTC from other changes. For a discussion of methodological principles see IAC (1987).

The experiments considered are not exhaustive. There are other ways in which government agencies can achieve savings from CTC than those modelled in this exercise. Judgement was used, however, in selecting assumptions which are typical of the perceived effects of CTC based on previous studies on CTC and comments by participants in the IC workshop, held in December 1995 after the release of the draft report (see appendix A for a list of participants).

The CTC of services by government agencies and government trading enterprises (GTEs) will have direct effects on the costs of providing services. The discussion in chapters B3 and B4 and appendix E suggests that the cost savings will be made predominantly through changes in the use of labour or in the wage rate. For the purpose of this exercise, therefore, the cost savings from CTC are attributed to two factors. First, cost savings are assumed to occur as a result of productivity improvements which reduce the amount of labour required to produce a given level of services. Second, cost savings may also be attained by reductions in the real wage paid per employee.²

There is also some evidence that costs may be reduced through savings on the use of capital. For this reason sensitivity tests were undertaken, allowing some savings to result from the better use of capital inputs. Although the results from these exercises are not presented in this appendix, they indicate that attributing a greater role to capital in achieving cost savings does not significantly alter the broad results; it does, however, reduce the estimated frictional unemployment from CTC.³

The first part of this appendix provides estimates of the range of potential cost reductions achievable from CTC by government agencies and GTEs. This draws on material presented in attachment G1 regarding the current use and potential for further use of CTC. The second part of the appendix considers the economy-wide effects of CTC by using this information in a general equilibrium model of the Australian economy.

The focus of this appendix is therefore on quantifying the implications of a range of possible effects of the greater use of CTC. In this way, the analysis is different from that undertaken in *The Revenue Implications of Hilmer and Related Reforms* (IC 1995b). In addition, there are substantial differences in the

² Real wage reductions may occur through lower real monetary wages or through changes in other monetary or non-monetary compensation. Examples of such other compensations are employer contributions to superannuation and subsidies on housing, recreation, etc. These costs are included in the cost of employing labour.

³ The term 'frictional' unemployment is used here to mean job losses created while labour markets adjust to meet changes in demand for labour by firms. Because these adjustments take time, the demand and supply of labour may not equate in every sector, so that unemployment may occur while the adjustments take place.

coverage. In particular, this report considers CTC in GTEs, which were treated separately in IC 1995b. Further, this report is only concerned with recurrent expenditure by government agencies and GTEs, whereas IC 1995b considered government investment expenditure.⁴ As a consequence of these differences it is not meaningful to directly compare the economy-wide impacts of each study.

Impact of CTC on the government sector

The potential to implement CTC differs according to the type of service provided, as does the savings that can be achieved. In order to determine the effects of greater CTC use on the economy as a whole, however, information is required on the effects of CTC by industry groups. Within each industry group, there are many types of services. Even if it were possible to quantify the effects of greater CTC use by different types of service, it is not possible to precisely identify the services in each industry grouping. Instead this analysis begins by forming estimates of the potential for CTC in each industry. Within each industry information is required on:

- the proportion of government recurrent expenditure that can be further subject to CTC (the value of further contractable services);⁵
- the savings rate on further contractable services; and
- the sources of the savings.

As there is uncertainty regarding this information, a range of estimates is used. Specifically, there are two estimates of:

- the value of further contractable services in government agencies and GTEs. These are referred to as case *A* and case *B* in the following discussion and are presented in table G.1;
- the savings per dollar of further contractable services. These are 20 and 10 per cent; and
- the division of total savings between labour saving productivity improvements and reductions in wages and conditions. First, productivity change is assumed to account for 75 per cent of the savings, and 25 per cent are due to changes in wages and conditions. Second, the division of productivity to wage effects is 50:50.

⁴ See attachment G2 for a detailed exposition of some of the differences between the reports.

⁵ The term 'contractable' is used here to mean services which may be subject to CTC. This appendix uses the terms 'achievable contractable services'; 'existing use of CTC' and 'further contractable services'. In some literature these concepts are referred to as 'scope for CTC', 'services currently under CTC', 'potential further use of CTC', respectively.

The range of estimates used in each case is considered to be conservative. There was some contention about the size of these estimates during the discussion in the IC workshop. This highlights the difficulty of quantifying CTC and the need for some latitude in interpreting the results.

The first task is to estimate the value of further contractable services within each industry. Column 1 of table G.1 shows the expenditure of government agencies and GTEs in producing services within each of the industries. The values reported relate to recurrent expenditures and exclude capital expenditures. The public administration sector is the largest industry, accounting for 28 per cent of government expenditure.

Ideally one would like to estimate the amount of this expenditure that could be subject to CTC on the basis of the services provided by government within each industry. Unfortunately, the information on the services is too imprecise. As a result an approximate approach is taken here. The value of achievable contractable expenditure within each industry is rated as either 10 per cent, 30 per cent or 50 per cent of government recurrent expenditure. The rating was made on the basis of several criteria which include: the cost share of labour and capital in each industry; the potential or actual competition from alternative service providers; government policies on CTC; the level of government at which expenditure occurs; and available evidence from Australian jurisdictions and overseas on the feasibility of introducing CTC.⁶

Using these proportions on the recurrent expenditures, in column 1, gives the estimate of the value of contractable services in each industry, shown in column 2 of table G.1.

The value of further contractable government services in each industry then depends on the value of achievable contractable services in the particular industry (column 2), and the estimated value of services currently under CTC (column 3). The difference between these values is an estimate of the value of further contractable services (case A, column 4). Halving the value of further contractable services provides an alternative estimate (case B, column 5). The values in Columns 4 and 5 indicate that public administration accounts for the largest fraction of potential CTC, equal to 35 per cent of total value of further contractable services.

⁶ These criteria are not intended as a guide for determining the services suitable for CTC. Rather, their use assists in estimating the amount of CTC which may be achievable at the more aggregated industry level required for the modelling exercise.

Table G.1: Estimated values of achievable contractable services, services currently under CTC, and further contractable services, 1993-94^a (\$m)

<i>Industry</i>	(1) <i>Expenditure by government agencies and GTEs^b</i>	(2) <i>Value of achievable contractable services</i>	(3) <i>Value of services currently under CTC</i>	(4) <i>Value of further contractable services (case A)</i>	(5) <i>Value of further contractable services (case B)</i>
Services to agriculture	71	35.5	6.9	28.6	14.3
Forestry & logging	405	202.5	80.0	122.5	61.2
Fishing & hunting	1	0.5	0.1	0.4	0.2
Coal, oil & gas	307	30.7	5.9	24.8	12.4
Meat products	96	14.6	5.0	9.6	4.8
Milk products	280	28.0	5.4	22.6	11.3
Commercial printing	8	4.0	2.0	2.0	1.0
Pharmaceutical products etc	172	17.2	8.9	8.3	4.2
Non-ferrous metals	1 739	173.9	33.7	140.2	70.1
Aircraft	155	46.5	24.1	22.4	11.2
Electricity	18 761	2 509.7	764.0	1 745.7	872.8
Gas	863	91.1	19.7	71.4	35.6
Water, sewerage, etc	3 175	952.5	130.8	821.7	410.9
Construction nec	1 679	839.5	162.5	677.0	338.5
Wholesale trade	5 237	1 572.3	592.3	980.0	490.0
Retail trade	2	0.6	0.1	0.5	0.3
Road transport	939	469.5	104.2	365.3	182.6
Railway transport	5 719	1 715.7	231.6	1 484.1	742.1
Water transport	504	66.8	31.9	34.9	17.5
Air transport	5 706	570.6	296.2	274.4	137.2
Services to transport	1 446	723.0	308.7	414.3	207.2
Communication	11 780	3 534.0	1 834.7	1 699.3	849.7
Non-bank finance	36	18.0	15.2	2.8	1.4
Investment, etc	30	15.0	10.0	5.0	2.5
Business services nec	867	433.5	158.8	274.7	137.4
Public administration	40 522	13 097.4	4 902.5	8 194.9	4 097.5
Defence	9 301	2 790.3	1 100.0	1 690.3	845.2
Health	11 844	3 553.2	687.6	2 865.6	1 432.8
Education, museums, etc	11 274	1 127.4	229.9	897.5	448.7
Welfare, religious inst., etc	5 350	535.0	127.0	408.0	204.0
Entertainment & recreation	3 392	339.2	83.9	255.3	127.7
Restaurants, hotels & clubs	35	10.5	5.5	5.0	2.5
Personal services	7	3.5	0.7	2.8	1.4
Totals^c	141 703	35 521.7	11 970.0	23 551.7	11 775.9

a Includes all levels of government.

b General government current expenditure and GTE operating expenditure.

c Columns may not sum exactly to totals as a result of rounding.

Source: Attachment G1

An estimate of the total cost reductions (savings) as a result of CTC is obtained by multiplying the total value of further contractable services by an estimate of the savings per dollar of expenditure. Over 50 per cent of the estimates of cost savings from the Australian studies, reported in appendix E, are between 10 and 30 per cent.⁷ As stated in the appendix, however, these studies were unable to incorporate all the relevant costs of service provision. These omissions often include monitoring costs, capital costs, the correct imputation of taxes, and some transaction and transition costs. The omission of these costs results in an underestimate of the true costs of both internal provision and contracting. It is, therefore, difficult to determine the direction of the bias they cause on the estimated cost savings. Furthermore, the method employed to estimate these cost changes did not usually control for changes in service levels or quality. Because of these uncertainties, relatively conservative estimates of the cost savings of 20 per cent and 10 per cent are used.

The discussion in chapter B3 and appendix E indicates that there is also uncertainty as to the relative contributions of productivity improvements (that result from reduced employment) and reductions in wage and conditions, in achieving cost reductions through CTC. Again being conservative, it is assumed that the contribution of productivity improvements lies between 75 and 50 per cent of the cost reduction. Thus, in one set of scenarios the division of cost reductions between productivity improvements and wage reductions is 75:25. In an alternative set of scenarios this division is 50:50.

The combination of these assumptions gives a total of eight different scenarios, as listed in table G.2.

Each entry in table G.2 shows the total savings as a percentage of total general government and GTE recurrent expenditure and the contribution of productivity and wage effects in the total savings. For example, applying a 20 per cent savings rate in case A, results in aggregate potential savings of approximately 3.3 per cent of total general government and GTE recurrent expenditure. This is worth around \$4.7b in 1993-94 dollars.⁸ Assuming that productivity accounts for 75 per cent of the savings, 2.49 per cent of recurrent expenditure is saved through productivity improvements and 0.83 per cent through wage reductions. This is scenario 1A of table G.2.

⁷ Basing an estimate of the average cost savings that could be achieved on the distribution of these estimates may be misleading if there is a correlation between the size of the contract and the percentage size of the savings.

⁸ All reported dollar values in this appendix refer to 1993-94 dollars following the latest ABS public finance statistics for the 1993-94 financial year.

Table G.2: Cost reductions due to changes in productivity and wages and conditions (per cent of 1993-94 expenditure)

		case A			case B		
<i>Percentage of savings due to productivity improvements and wage reductions</i>		<i>Savings from productivity improvements</i>	<i>Savings from wage reductions</i>	<i>Total savings</i>	<i>Savings from productivity improvements</i>	<i>Savings from wage reductions</i>	<i>Total savings</i>
<i>cost reduction of 20 per cent</i>							
(1)	75:25	2.49	0.83	3.32	1.25	0.42	1.66
(2)	50:50	1.66	1.66	3.32	0.83	0.83	1.66
<i>cost reduction of 10 per cent</i>							
(3)	75:25	1.25	0.42	1.66	0.63	0.21	0.83
(4)	50:50	0.83	0.83	1.66	0.42	0.42	0.83

Note: Scenarios are indexed by row and column headings, for example, scenario 1A represents assumed savings of 20 per cent where 75 per cent of those savings are the result of productivity improvements and 25 per cent are the result of wage reductions.

The scenarios outlined in table G.2 indicate that considerable savings are assumed to be achieved by improvements in labour saving productivity. The implied direct adjustments to employment as a consequence of these labour saving productivity gains (assuming that the level of government services is held fixed) are shown in table G.3.

These estimates refer to the number of full-time jobs that would be lost if there was no expansion in the output of the sector, and if the government agency or GTE did not retain any more labour than was essential after CTC. They can, therefore, be thought of as an estimate of the short-term frictional unemployment associated with introducing CTC. For example, in scenario 1A, the equivalent of approximately 74 700 full-time jobs would be cut by successful tender applicants, after the tendering process.

The initial reduction in employment will impose adjustment costs, not only on those directly affected by job losses, but also on the Commonwealth Government's budget. It is likely that some government outlays, such as unemployment benefits and training program funds, would increase. Similarly, government taxation revenue may fall as a consequence of the lower number of income earners. These adjustment costs should, however, be viewed relative to the economy-wide gains that may be realised through further use of CTC. The following section therefore presents the economy-wide results obtained using the ORANI model.

Table G.3: Estimated frictional unemployment from CTC based on 1993-94 labour force estimates (full-time equivalents)

		case A		case B	
<i>Percentage of savings due to productivity improvements and wage reductions</i>		<i>Reduction in full-time equivalent jobs</i>		<i>Reduction in full-time equivalent jobs</i>	
		<i>% of total labour</i>	<i>000's</i>	<i>% of total labour</i>	<i>000's</i>
<i>cost reduction of 20 per cent</i>					
(1)	75:25	1.23	74.7	0.61	37.4
(2)	50:50	0.82	49.8	0.41	24.9
<i>cost reduction of 10 per cent</i>					
(3)	75:25	0.61	37.4	0.31	18.7
(4)	50:50	0.41	24.9	0.20	12.5

a A full-time job is defined to be 40.9 hours per week (the average full-time worker weekly hours from November 1994 to October 1995).

Sources: Commission estimates and ABS cat. no. 6203.0, various issues

Economy-wide impacts of contracting

The cost impacts of increases in the use of CTC in providing government agency and GTE services are used to estimate the economy-wide impact of implementing CTC. The experiments were conducted with the ORANI model of the Australian economy (see box G.1).

Broad results of the analysis are presented in tables G.4a and G.4b. In scenario 1A, (table G.4a) there are significant economy-wide gains from CTC, with an annual on-going increase in gross domestic product (GDP) of approximately 1.7 per cent (\$7.3b in 1993-94 dollars) and an increase in aggregate consumption of 1.1 per cent.⁹ This occurs partly as a result of the labour-saving efficiency gains that allow other industries to employ more labour without bidding up wages. The increase in productivity also results in price decreases and reductions in government tax requirements, resulting in an increase in consumer real incomes.¹⁰ The increased purchasing power is reflected in an increased demand

⁹ The percentage increase in consumption in all scenarios is less than the percentage increase in GDP. This reflects empirical evidence that the fraction of income which is consumed falls as income rises.

¹⁰ In these experiments the way in which savings are distributed across the economy depends on how the government is assumed to behave. It is assumed here that there is no change in

for Australian (and imported) commodities by residents. This increases the demands for capital and labour, resulting in an economy-wide expansion in output and employment.

The benefits of lower costs in government agencies and GTEs are also passed on to industries that purchase their services as intermediate inputs. For example, cost reductions in public administration services will be passed onto businesses which purchase information, pay administration and regulation fees and otherwise depend on services provided by the public sector. Cost savings in these industries allow lower prices which in turn result in increased sales.

In scenario 1A, the average real wage increases by just over 1 per cent. This partly reflects the impact of the increase in productivity. It is also related to the increase in investment. Industries increase investment in order to expand output to meet increased demand levels. This results in higher capital–labour ratios and higher wages.¹¹

These results refer to gains from CTC across all government agencies and GTEs included in table G.1. Because of its sheer size in terms of expenditure and employment, the public administration sector has the largest impact on the economy as a result of CTC. Other sectors where there is a large absolute potential for extending the use of CTC are health, defence, rail transport, communications and electricity. The contribution of each of these sectors to the macro-economic results is approximately proportional to the size of the potential for further CTC calculated for each sector.

Although these sectors provide the largest indirect gains, the sectors with the largest contribution to increases in GDP are the larger industries that also have intermediate linkages to government agency and GTE sectors. These are the construction and housing sectors, electricity, business services, transport and communications services, and non-ferrous metal industries.

government policy so that the experiments leave government spending levels and borrowing requirements unchanged. While this affects the distribution of gains between industries, it does not significantly alter the overall magnitude of the reported gains from CTC.

¹¹ These results report the effects in the longer term, where industries can alter their plant size. In this case, competition induces firms to expand capital inputs so that the rate of return is reduced to the original level.

Box G.1: The ORANI model

The ORANI model is a general equilibrium model of the Australian economy which has been used over the past two decades for policy analysis. The version of the model used in this exercise fully accounts for changes in government revenue and expenditure that may result from the modelled policy changes. Model details are found in Dixon *et al.* (1982), Dee (1989) and McDougall and Skene (1992).

In this report, ORANI projections are taken to depict long-run results. Long-run results refer to a period during which it has been possible to adjust industry capital stocks in response to changes in industry profitability. In the long-run ORANI environment, there is a government borrowing constraint. In this report, the levels of services provided by government, such as schools and health, is also assumed to be fixed. This means that any savings achieved in providing services will reduce the government's revenue requirements.

The long-run ORANI environment also treats the unemployment rate as fixed. This is because the aim is to model the longer term effect on the economy, irrespective of business cycle effects. Rising real wages may, nevertheless, lead to increases in participation rates.

The changes associated with each scenario are simulated as the combination of a change in unit input requirements per unit output of services (units are measured in dollars) and a change in the wages and conditions paid to workers.

The results generated by ORANI indicate how different the economy would look at sometime in the future compared with its alternative position without the policy change. They are presented as percentage changes between these two positions. The path of adjustment is not traced by the model.

Some costs associated with transferring production from the public to the private sector are not accounted for. Specifically, resources required to enable employees that may be displaced by the introduction of CTC to find new jobs, or the unemployment benefits they may require in the interim are not taken into account.

The database underlying the ORANI model is constructed from the Australian Bureau of Statistics (ABS 1994b) input-output accounts for 1989-90. It describes the structure of the economy in terms of inter-industry and final demands for commodities, and demands for primary factors. The database also incorporates a full description of government accounts covering revenues from all forms of taxes as well as expenditures, transfers and subsidies.

The results of other scenarios show how the results change when the assumptions regarding the size of cost savings, and means of achieving cost savings, are varied. Scenario 2A shows the results of assuming a greater contribution for wage reductions in achieving the savings from CTC. The increase in GDP in this case is just over 1 per cent, substantially lower than the estimate of 1.7 per cent in scenario 1A. Thus, even though the same total

savings is assumed to be achieved by government agencies and GTEs, there is a much smaller economy-wide gain. This is because savings from reducing wages do not necessarily result in a net creation of income in the economy. Consumers are able to purchase government agency and GTE services at lower costs, thus real incomes are increased. Similarly, firms can purchase government agency and GTE services at lower prices, and pass the cost savings on to consumers in the form of lower prices. Offsetting these real income gains, however, are decreased real incomes of households whose wages are reduced by CTC. In this sense, the wage reductions represent transfers of income from employees to consumers.

The source of cost savings is therefore important in terms of economy-wide effects. If savings are due to productivity improvements, this produces an opportunity for growth in the economy. Cost savings through reduced wages and entitlement, do not necessarily provide such opportunities.

Scenario 3A shows the effects of reducing the assumed cost savings from 20 per cent to 10 per cent (given the same estimates of further contractable services as scenario 1A). Economic activity still expands in this case, but the expansion is approximately half of that attained in scenario 1A (0.8 per cent versus 1.7 per cent). Thus, within the range of 10-20 per cent cost savings, a one per cent reduction in the costs of services under CTC results in a 0.08 per cent increase (\$343m in 1993-94 dollars) in GDP. Scenario 4A shows the results of assuming that the division between wages and productivity effects in achieving a reduction in costs is 50:50 and that the percentage savings is 10 rather than 20 per cent. The combination of these assumptions again reduces the economy-wide gains from CTC.

Table G.4a: Estimated aggregate effects from CTC, case A
(per cent changes)

	<i>Scenario 1A</i>	<i>Scenario 2A</i>	<i>Scenario 3A</i>	<i>Scenario 4A</i>
Real aggregates				
Real GDP	1.72	1.07	0.83	0.53
Real consumption	1.10	0.67	0.52	0.32
Real investment	2.01	0.88	1.02	0.45
Export volume	4.62	3.37	2.25	1.67
Import volume	1.09	0.53	0.54	0.27
Real post-tax wage	1.26	0.72	0.59	0.35
Aggregate employment	0.07	0.03	0.03	0.02
Price indexes				
Consumption	-1.13	-0.83	-0.56	-0.41
Government consumption	-3.25	-2.87	-1.60	-1.43
Exports	-0.45	-0.32	-0.22	-0.16

Source: Results from ORANI-IC92

Table G.4b: Estimated aggregate effects from CTC, case B
(per cent changes)

	<i>Scenario 1B</i>	<i>Scenario 2B</i>	<i>Scenario 3B</i>	<i>Scenario 4B</i>
Real aggregates				
Real GDP	0.83	0.53	0.42	0.27
Real consumption	0.52	0.32	0.26	0.16
Real investment	1.02	0.45	0.61	0.28
Export volume	2.25	1.67	1.17	0.92
Import volume	0.54	0.27	0.38	0.22
Real post-tax wage	0.59	0.35	0.30	0.19
Aggregate employment	0.03	0.02	0.01	0.01
Price indexes				
Consumption	-0.56	-0.41	-0.15	-0.11
Government consumption	-1.60	-1.43	-0.69	-0.62
Exports	-0.22	-0.16	-0.09	-0.06

Source: Results from ORANI-IC92

Table G.4b reports the results under case *B*, with lower estimates of the potential for further CTC.¹² The interpretation of these results follows the

¹² The results for scenario 1B and 2B are the same as those for 3A and 4A. This follows from the fact that the implications for savings are the same in both cases (see tables G.2 and G.3). Thus, halving the estimates of potential for further use has the same effect on the

results in table G.4a. Estimates of economy-wide effects are lower as a consequence of the more conservative assumptions regarding the potential for further CTC.

Thus, the economy-wide effects are sensitive to the assumptions regarding the potential for further CTC, the savings per dollar of contracted services and the source of savings. Depending on these assumptions, the total gains range from about 0.3 to 1.7 per cent of GDP. The results in table G.4a and G.4b also show that in the long run there is a small increase in total employment (equivalent to between 500 and 4 400 jobs) in response to an increased demand for labour. Thus, the initial unemployment created by CTC is more than offset by increases in employment across the economy as a whole, as firms hire more labour to meet increased consumer and producer demands.

The longer term job creation by industry for scenarios 1A and 4B is shown in table G.5.

The pattern of differing growth rates across industries is sensitive to the assumptions of the modelling exercise, in particular how government distributes the savings attained from CTC. In the scenarios presented here it is assumed that the savings are not used by government to expand the volume or quality of services provided, so that government service industries do not expand as much as the private sector. The results, however, indicate which private sector industries, and GTEs, are likely to experience the most growth as a consequence of the increased consumer and producer demand.

The public administration industry accounts for most of the reductions in employment, with reductions between 3 000 and 22 200 jobs, depending on the scenario considered. There are similar employment reductions in other industries with government involvement, especially defence, banking and health. The employment benefits of CTC, by contrast, are spread across a range of industries. The amount of employment creation depends upon the degree to which an industry expands in response to increased investment and consumer and producer demands, and changes in the cost of employing labour relative to alternative production methods. Of particular importance are the construction and residential industries, and the wholesale and retail industries. There is also some expansion in employment in the resource agricultural and sectors, especially wheat and sheep agriculture, and black coal industries. The increases in employment in these resource sectors are largely determined by increased export demand in response to domestic price decreases.

estimate of the savings from CTC as halving the estimates of savings per dollar of contractable services.

Table G.5: Estimated range of employment effects on selected industries ^a (in full-time equivalents^b)

<i>Industry</i>	<i>Number of workers in industry prior to further CTC (000's)</i>	<i>Change in number of workers after Scenario 1A (000's)</i>	<i>Change in number of workers after Scenario 4B (000's)</i>
Wheat-sheep agriculture	166.59	7.32	1.25
High rainfall agriculture	67.63	1.47	0.21
Other export oriented farming	45.98	1.62	0.25
Non-ferrous metal ores	23.87	1.22	0.21
Black coal	29.49	3.25	0.61
Other Food products	21.97	1.26	0.19
Non-ferrous metals	25.81	1.61	0.32
Motor vehicles etc	53.52	1.28	0.17
Electricity	50.12	-2.82	0.00
Water, sewerage, etc	26.22	-2.73	-0.12
Residential building	223.19	3.74	0.44
Other Construction	317.28	4.68	0.38
Wholesale trade	386.04	3.57	0.50
Retail trade	653.75	5.24	0.63
Mechanical repairs	178.52	2.07	0.26
Road transport	180.59	1.86	0.29
Railway transport	59.06	-1.78	-0.17
Communication	100.18	-3.43	-0.18
Banking	142.41	-4.97	-1.43
Insurance etc	76.00	1.00	0.14
Other Business services	412.25	2.37	0.17
Public administration	260.24	-22.20	-3.05
Defence	77.60	-5.92	-1.02
Health	378.69	-4.05	-0.50
Education, museums, etc	354.27	-2.30	-0.38
Restaurants, hotels & clubs	210.41	2.00	0.21
Economy-wide	6030.68	4.42	0.50

a The industries included in this table consist of those in which the workforce is estimated to change by at least 1000 workers in Scenario 1A.

b A full-time job is defined as 40.9 hours per week (the average full-time worker weekly hours from November 1994 to October 1995).

Sources: Commission estimates and ABS cat. no. 6203.0, (ABS, 1995a) various issues

These results reflect the outcomes of longer term adjustments in the labour force. In the short or medium term the balance of costs and benefits may be less favourable, especially if labour markets are slow to adjust. If only a fraction of the potential job creation is realised, due for example to regional adjustment problems, price and wage rigidities, or skill matching problems, then the income and consumption gains will be lower. Thus the magnitude of the economy-wide gain from CTC is conditional upon the efficient operation of the economy, and

in particular the efficiency of the labour market in responding to changes in productivity and consumer demands.

In conclusion, the Commission's modelling indicates that the further use of CTC in government services has the potential to generate significant economy-wide effects. The main points of the analysis are summarised below:

- **There is considerable uncertainty surrounding the value of achievable contractable services. The analysis used a conservative methodology to estimate the value of achievable contractable services in each industry. It nevertheless indicated that substantial scope exists for further CTC in government agencies and GTEs. The cost savings implied by these estimates ranged from 0.8 to 3.3 per cent of government recurrent expenditure, or \$1.2b to \$4.7b.**
- **The economy-wide impacts of CTC will depend on the mix of productivity improvements and wage reductions that occurs in attaining the cost reductions. If contracting leads to productivity improvements then there are substantial real economy-wide gains. If 75 per cent of cost reductions are attributable to productivity improvements (scenarios 1A, 1B, 3A and 3B), then annual GDP is likely to be between 0.4 and 1.7 per cent (\$1.7b to \$7.3b in 1993-94 dollars) larger than if further CTC was not implemented.**
- **If wage reductions are an important component of the cost reductions, the economy-wide benefits to CTC are likely to be smaller. If the division between productivity gains and wage cuts in achieving cost reductions is 50:50 (scenarios 2A, 2B, 4A and 4B), annual GDP is likely to be between 0.3 and 1.1 per cent larger (\$1.3b to \$4.7b in 1993-94 dollars).**
- **The productivity improvements required to generate cost savings and economy-wide gains are likely to result in frictional unemployment of between 12 500 and 74 700 full-time equivalent jobs. There is, however a net economy-wide increase in employment of between 500 and 4 400 full-time equivalent jobs as a result of the increase in economic activity.**

Attachment G1 Estimating the current use and the potential for further use of CTC

Estimating the impact of increased use of CTC on the Australian economy requires estimates of the values of achievable contractable services and services currently under CTC. From these estimates, an estimated value of further contractable services can be obtained for each of the relevant industries.¹³

A framework for estimating the achievable savings from CTC in Australia was constructed by Domberger (1989). Domberger estimated the scope for, and existing use of, CTC for government services to allow an estimate of the potential further use of CTC. An assumed 20 per cent cost reduction was then applied to this portion of government expenditure to obtain an estimate of the additional savings that could be obtained by the maximum further use of CTC. Domberger's estimates of scope and existing use were subsequently revised by Rimmer (1991a). In doing so, Rimmer drew on, where possible, available information from within Australia. Where this information did not exist, he analysed the international evidence on the use of contracting and applied similar estimates to those made overseas for the relevant services. In turn, Rimmer revised these estimates in 1994 with the advent of further information.¹⁴

The Commission, while drawing on the method used by the above researchers, has compiled its own set of estimates of achievable contractable services and services currently under CTC. This has, in part, been necessitated by the different data classification required for this analysis. Domberger (1989) and Rimmer (1991a) used Government Purpose Classification (GPC) data in their research, which enabled the main functions of government to be readily identified. The ORANI simulations required input by Input–Output Industry Group (IOIG) classification to allow compatibility with the structure of the model's database. As a result, the classifications of government activity used in this analysis are not readily comparable with those of either Domberger or Rimmer.

¹³ Due to the uncertainty surrounding the accuracy of these estimates, particularly the estimated values of achievable contractable services, alternative values of further contractable services (equalling half the estimated values) have also been used in the modelling.

¹⁴ Rimmer's latest estimates of scope and existing use, along with the savings arising from an assumed 20 per cent cost reduction from CTC, appear in table B3.1 of the Industry Commission report *The Growth and Revenue Implications of Hilmer and Related Reforms* (IC 1995b). Table B3.1 and the input used for the modelling simulations in that report also included capital expenditure estimates. The analysis for this inquiry uses current expenditure data only and the impacts reported should be viewed accordingly.

In estimating the achievable contractable services of government, the Commission has applied ratings of either high, medium or low potential for contracting in each relevant industry. For quantitative purposes a high rating translates to 50 per cent of government recurrent expenditure, a medium rating to 30 per cent and a low rating to 10 per cent. A high rating, for example, means that it is estimated that 50 per cent of the services (as measured by recurrent expenditure value) provided by government in that industry could conceivably be contracted.

A number of criteria have been used in making these ratings. They are:

- the cost share of primary inputs, in particular labour, in the total costs identified in the cost structure for each relevant industry as described by the ORANI database and the ABS 1989-90 input-output table. Given that there is considerable evidence that the cost advantages of CTC are derived primarily from reductions in employment and wages and, to a lesser extent, payments to capital, the achievable amount of CTC (and the implied cost savings) would appear to be greater in those industries in which labour costs comprise a sizeable proportion of total costs;
- the existence of alternative service providers and threat of competition from potential alternative providers. The absence of competition, possibly arising from public good characteristics of services, will prevent the use of CTC. A greater amount of CTC should exist where evidence suggests that services delivered directly by government can be provided by other means;
- government policy decisions on which services are deemed contractable. For example, certain combat activities are considered unsuitable for CTC. Similarly, some services within the Justice sector may not be subject to CTC for political reasons. The greater the proportion of government activities in an industry precluded from CTC as a matter of policy, the smaller the achievable amount of CTC;
- the level of government at which expenditure occurs. In general, service delivery constitutes a larger proportion of total expenditure at lower levels of government. For example, the provision of services by local government (such as building and health inspection, waste collection and maintenance of recreational facilities), comprises a larger share of total costs than at the Commonwealth level, where policy-making responsibilities are more prominent; and
- evidence from Australian jurisdictions and overseas on the amount of CTC achievable. In using this experience as a guide, there is a need to keep in mind possible institutional and constitutional or other legal differences which may arise. Chapter A2 provides a summary of the available evidence on the extent of the use of CTC in Australia and other countries.

The resulting estimates of the achievable contractable services of government are reported in tables G.6 to G.9. The base expenditure estimates were obtained from unpublished ABS 1993-94 data on general government current expenditure and GTE operating expenditure. This data includes expenditure on wages and salaries, depreciation charges, indirect taxes and purchases of intermediate inputs by government within each of the industry classifications.¹⁵ Separate estimates are available for the Commonwealth, state and territory, and local levels of government, enabling estimates of achievable contractable services (and services currently under CTC) to be made for each level of jurisdiction, in addition to the aggregated level. Rating the amount of CTC achievable by the above criteria resulted in a total estimate of \$35.5 billion for all levels of government. This consisted of estimates of \$14.2 billion at the Commonwealth level, \$17.8 billion at the state and territory level and \$3.5 billion at the local government level.

In some instances the estimates of achievable contractable services may be conservative. For example, the amount achievable in commercial printing may well be in excess of the 50 per cent of expenditure allocated. However, the 'rule of thumb' described above was applied consistently.

There is little substantive information on the extent of government services currently under CTC in a form compatible with the ORANI industry classification. However, some aggregate information for the 1993-94 financial year is available. This was used to calibrate the industry estimates.

An estimate of \$7 billion worth of CTC in 1993-94 was made for the Commonwealth level. This estimate was obtained through information available from contracts gazetted with the Australian Government Publishing Service and from the survey of government departments undertaken for the Commission.¹⁶

Data from surveys in New South Wales, Victoria and Western Australia, along with other information available to the Commission, assisted in estimating services currently under CTC at the state and territory level. Their reported value of CTC in 1993-94 was extrapolated to all States and Territories to obtain an estimate of \$3.27 billion.

There was less data available to the Commission at the local level on the current use of CTC. However, information gathered from industry visits, submissions

¹⁵ The GTE operating expenditure includes all of these costs. However, the general government current expenditure excludes depreciation charges and indirect taxes.

¹⁶ The estimate for 1993-94 is consistent with the estimate of \$8 billion worth of CTC for the following year discussed in chapter A2. The available information indicates that the extent of contracting in 1994-95 at the Commonwealth Government level increased quite significantly from the previous year.

and hearings during the course of the inquiry resulted in an estimate of \$1.7 billion in services currently under CTC by local governments. This estimate is based on indications that CTC already accounts for approximately 20 per cent of local government recurrent expenditure.

A comparison of these estimates with the aggregate estimates at each government level of achievable contractable services shows that the estimated services currently under CTC is nearly half of the estimated achievable contractable services at the Commonwealth and local levels, while it is less than 20 per cent at the state and territory level.

Direct estimates of services currently under CTC in industries by government level were made where more specific information was available to the Commission. These cases are identified in tables G.6 and G.7 by table notes. For example, the Department of Defence provided information that the value of contracts broadly defined as relating to services which were gazetted during 1993-94 amounted to about \$1.1 billion. Similarly, information obtained from state surveys indicated that contracts let by State and Territory governments in the forestry industry may be in the order of \$80 million. Other industries at this level where direct estimates could be made include commercial printing; water, sewerage and drainage; railway transport; water transport; services to transport; non-bank finance; and investment, etc. No direct estimates were available at the local level.

Once the estimates of services currently under CTC and achievable contractable services estimates for these industries were separated out, the ratios of the remaining services currently under CTC to achievable contractable services estimates were 0.52:1 at the Commonwealth level, 0.19:1 at the state and territory level and 0.48:1 at the local level.¹⁷ These ratios were then applied to all other industries to obtain estimates of services currently under CTC.

Estimates of the value of further contractable services are obtained from the difference between the values of achievable contractable services and services currently under CTC. This amount, as a proportion of government expenditure in each industry, was used as input into the ORANI simulations. The assumed savings of 20 per cent and 10 per cent were then applied to the government expenditure identified as being contractable in the future.

¹⁷ The ratio of services currently under CTC to achievable contractable services for each government level when these industries were removed were (in billions of dollars):

\$5.900:\$11.365 at the Commonwealth level;

\$2.903:\$15.000 at the state and territory level; and

\$1.700:\$3.535 at the local level.

An example from the tables demonstrates the method used. The 1993-94 recurrent expenditure by all governments in the aircraft industry amounted to \$155 million. This consisted entirely of aircraft manufacturing expenditure at the Commonwealth Government level. Using the above criteria, it was estimated that the value of achievable contractable services was 30 per cent of government expenditure, or \$46.5 million. The appropriate ratio (0.52:1) estimated that the value of services currently under CTC was 15.6 per cent of government expenditure in this industry, or \$24 million. As a result, a further 14.4 per cent, or \$22 million, could still be contracted. The savings from the further contractable services then became a function of the size of the assumed cost reductions from CTC. Assuming a 10 per cent cost reduction resulted in an estimated saving of \$2.2 million, whereas assuming a 20 per cent cost reduction gave a saving estimate of \$4.5 million.

Apart from the extent of the estimated further contractable services (which, as shown, is a function of the amount of government expenditure, the estimated services currently under CTC and the estimated achievable contractable services) and the assumed size of the cost savings, the ORANI simulation shocks depend on the proportion of government expenditure in total industry costs. The larger the extent of government activity, the larger will be the impact of further CTC on the total costs in that industry. For example, table G.10 indicates that government produces all public administration output, while it contributes only a minimal amount of activity in the fishing and hunting industry. As a result, the impact of government CTC will be far greater in the former industry, other things being equal.

The share of government productive activity in a number of industries was estimated from 1993-94 data. The 1993-94 government recurrent expenditure was scaled down by the ratio of 0.75:1 to reflect the growth in nominal government expenditure from 1989-90 to 1993-94. The scaled down expenditure data could then be directly compared to the industry costs in the ORANI database (which consists of 1989-90 data) to obtain estimates of the government share of output in these industries.

Table G.6: Estimated values of services currently under CTC, achievable contractable services and further contractable services by the Commonwealth Government, 1993-94

Industry	Expend. ^a by govt. agencies and GTEs	Value of services currently under CTC		Value of achievable contractable services		Value of further contractable services	
	\$m	% of expend.	\$m	% of expend.	\$m	% of expend.	\$m
Services to agriculture	-						
Forestry & logging	-						
Fishing & hunting	-						
Coal, oil & gas	-						
Meat products	-						
Milk products	-						
Commercial printing	-						
Pharmaceutical products etc	172	5.2	8.9	10.0	17.2	4.8	8.3
Non-ferrous metals	-						
Aircraft	155	15.6	24.1	30.0	46.5	14.4	22.4
Electricity	159	5.2	8.3	10.0	15.9	4.8	7.6
Gas	-						
Water, sewerage, etc	-						
Construction nec	-						
Wholesale trade	2 940	15.6	457.9	30.0	882.0	14.4	424.1
Retail trade	-						
Road transport	-						
Railway transport	845	15.6	131.6	30.0	253.5	14.4	121.9
Water transport	422	5.2	21.9	10.0	42.2	4.8	20.3
Air transport	5 706	5.2	296.2	10.0	570.6	4.8	274.4
Services to transport	804	26.0	208.7	50.0	402.0	24.0	193.3
Communication	11 780	15.6	1 834.7	30.0	3 534.0	14.4	1 699.3
Non-bank finance	-						
Investment, etc	-						
Business services nec	460	26.0	119.4	50.0	230.0	24.0	110.6
Public administration	17 320	15.6	2 697.5	30.0	5 196.0	14.4	2 498.5
Defence	9 301	11.8 ^b	1 100.0	30.0	2 790.3	18.2	1 690.3
Health	-						
Education, museums, etc	360	5.2	18.7	10.0	36.0	4.8	17.3
Welfare, religious inst., etc	721	5.2	37.4	10.0	72.1	4.8	34.7
Entertainment & recreation	562	5.2	29.2	10.0	56.2	4.8	27.0
Restaurants, hotels & clubs	35	15.6	5.5	30.0	10.5	14.4	5.0
Personal services	-						
Totals^c	51 742		7 000.0		14 155.0		7 155.0

a General government current expenditure and GTE operating expenditure.

b This estimate is obtained from information supplied by the Defence Department. In its submission to the inquiry the Department stated that the value of contracts gazetted in 1993-94 amounted to \$1.1 billion.

c Columns may not sum exactly to totals as a result of rounding.

- No government recurrent expenditure was recorded.

Sources: Commission estimates based on ABS Cat. no. 5512.0, (ABS, 1995b), unpublished ABS data and submission information

Table G.7: Estimated values of services currently under CTC, achievable contractable services and further contractable services by State and Territory governments, 1993-94

Industry	Expend. ^a by govt. agencies and GTEs		Value of services currently under CTC		Value of achievable contractable services		Value of further contractable services	
	\$m	% of expend.	\$m	% of expend.	\$m	% of expend.	\$m	
Services to agriculture	71	9.7	6.9	50.0	35.5	40.3	28.6	
Forestry & logging	405	19.8 ^b	80.0	50.0	202.5	30.2	122.5	
Fishing & hunting	1	9.7	0.1	50.0	0.5	40.3	0.4	
Coal, oil & gas	307	1.9	5.9	10.0	30.7	8.1	24.8	
Meat products	71	1.9	1.4	10.0	7.1	8.1	5.7	
Milk products	280	1.9	5.4	10.0	28.0	8.1	22.6	
Commercial printing	8	25.0 ^c	2.0	50.0	4.0	25.0	2.0	
Pharmaceutical products etc	-							
Non-ferrous metals	1 739	1.9	33.7	10.0	173.9	8.1	140.2	
Aircraft	-							
Electricity	15 434	1.9	298.7	10.0	1 543.4	8.1	1 244.7	
Gas	839	1.9	16.2	10.0	83.9	8.1	67.7	
Water, sewerage, etc	2 615	1.9 ^d	50.0	30.0	784.5	28.1	734.5	
Construction nec	1 679	9.7	162.5	50.0	839.5	40.3	677.0	
Wholesale trade	2 291	5.8	133.0	30.0	687.3	24.2	554.3	
Retail trade	2	5.8	0.1	30.0	0.6	24.2	0.5	
Road transport	846	9.7	81.9	50.0	423.0	40.3	341.1	
Railway transport	4 874	2.1 ^e	100.0	30.0	1 462.2	27.9	1 362.2	
Water transport	82	12.2 ^f	10.0	30.0	24.6	17.8	14.6	
Air transport	-							
Services to transport	642	15.6 ^g	100.0	50.0	321.0	34.4	221.0	
Communication	-							
Non-bank finance	35	42.9 ^h	15.0	50.0	17.5	7.1	2.5	
Investment, etc	30	33.3 ^h	10.0	50.0	15.0	16.7	5.0	
Business services nec	407	9.7	39.4	50.0	203.5	40.3	164.1	
Public administration	18 498	5.8	1 074.0	30.0	5 549.4	24.2	4 475.4	
Defence	-							
Health	11 844	5.8	687.6	30.0	3 553.2	24.2	2 865.6	
Education, museums, etc	10 914	1.9	211.2	10.0	1 091.4	8.1	880.2	
Welfare, religious inst., etc	4 629	1.9	89.6	10.0	462.9	8.1	373.3	
Entertainment & recreation	2 830	1.9	54.8	10.0	283.0	8.1	228.2	
Restaurants, hotels & clubs	-							
Personal services	7	9.7	0.7	50.0	3.5	40.3	2.8	
Totalsⁱ	81 380		3 270.0		17 831.6		14 561.6	

a General government current expenditure and GTE operating expenditure.

b This estimate is obtained using information that the value of contracts for forestry services was more than \$60 million in Western Australia in 1993-94. While no other evidence of contracting by State and Territory governments in the forestry industry was available, an estimate of \$80 million of forestry services currently under CTC was made to allow for the possibility of a small amount of contracting by other governments.

c This estimate is based on information obtained in the surveys on CTC in New South Wales and Western Australia.

- d The annual value of contracts let by water authorities in New South Wales and Western Australia totalled approximately \$20 million in 1993-94. An estimate of \$50 million was made to allow for similar current use of CTC in other states and territories.
- e Approximately \$46 million of contracts were let by rail authorities in New South Wales and Western Australia in 1993-94. An estimate of \$100 million was made to allow for similar current use of CTC in other states and territories.
- f The survey on CTC in Western Australia reported contracts worth in excess of \$7 million in 1993-94 for port services. An estimate of \$10 million was made to allow for some additional current use of CTC in other states and territories.
- g According to survey and submission information, \$62 million worth of contracts for transport services existed in New South Wales, Victoria and Western Australia during 1993-94. This was assumed to be representative of the transport services currently under CTC in other states and territories, resulting in a total estimate of \$100 million.
- h According to survey and submission information, \$25 million worth of contracts for various financial services existed in New South Wales, Victoria and Western Australia during 1993-94.
- i Columns may not sum exactly to totals as a result of rounding.
- No government recurrent expenditure was recorded.
- Sources: Commission estimates based on ABS Cat. no. 5512.0 (ABS, 1995b), unpublished ABS data and submission information

Table G.8: Estimated values of services currently under CTC, achievable contractable services and further contractable services by local governments, 1993-94

Industry	Expend. ^a by govt. agencies and GTEs		Value of services currently under CTC		Value of achievable contractable services		Value of further contractable services	
	\$m	% of expend.	\$m	% of expend.	\$m	% of expend.	\$m	
Services to agriculture	-							
Forestry & logging	-							
Fishing & hunting	-							
Coal, oil & gas	-							
Meat products	25	14.4	3.6	30.0	7.5	15.6	3.9	
Milk products	-							
Commercial printing	-							
Pharmaceutical products etc	-							
Non-ferrous metals	-							
Aircraft	-							
Electricity	3 168	14.4	457.0	30.0	950.4	15.6	493.4	
Gas	24	14.4	3.5	30.0	7.2	15.6	3.7	
Water, sewerage, etc	560	14.4	80.8	30.0	168.0	15.6	87.2	
Construction nec	-							
Wholesale trade	6	24.0	1.4	50.0	3.0	26.0	1.6	
Retail trade	-							
Road transport	93	24.0	22.4	50.0	46.5	26.0	24.1	
Railway transport	-							
Water transport	-							
Air transport	-							
Services to transport	-							
Communication	-							
Non-bank finance	1	24.0	0.2	50.0	0.5	26.0	0.3	
Investment, etc	-							
Business services nec	-							
Public administration	4 704	24.0	1 131.1	50.0	2 352.0	26.0	1 220.9	
Defence	-							
Health	-							
Education, museums, etc	-							
Welfare, religious inst., etc	-							
Entertainment & recreation	-							
Restaurants, hotels & clubs	-							
Personal services	-							
Totals^b	8 581		1 700.0		3 535.1		1 835.1	

a General government current expenditure and GTE operating expenditure.

b Columns may not sum exactly to totals as a result of rounding.

- No government recurrent expenditure was recorded.

Sources: Commission estimates based on ABS Cat. no. 5512.0 (ABS, 1995b), unpublished ABS data and submission information

Table G.9: Estimated values of services currently under CTC, achievable contractable services and further contractable services by all governments, 1993-94

Industry	Expend. ^a by govt. agencies and GTEs		Value of services currently under CTC		Value of achievable contractable services		Value of further contractable services	
	\$m	% of expend.	\$m	% of expend. ^b	\$m	% of expend.	\$m	
Services to agriculture	71	9.7	6.9	50.0	35.5	40.3	28.6	
Forestry & logging	405	19.8	80.0	50.0	202.5	30.2	122.5	
Fishing & hunting	1	9.7	0.1	50.0	0.5	40.3	0.4	
Coal, oil & gas	307	1.9	5.9	10.0	30.7	8.1	24.8	
Meat products	96	5.2	5.0	15.2	14.6	10.0	9.6	
Milk products	280	1.9	5.4	10.0	28.0	8.1	22.6	
Commercial printing	8	25.0	2.0	50.0	4.0	25.0	2.0	
Pharmaceutical products etc	172	5.2	8.9	10.0	17.2	4.8	8.3	
Non-ferrous metals	1 739	1.9	33.7	10.0	173.9	8.1	140.2	
Aircraft	155	15.6	24.1	30.0	46.5	14.4	22.4	
Electricity	18 761	4.1	764.0	13.4	2 509.7	9.3	1 745.7	
Gas	863	2.3	19.7	10.6	91.1	8.3	71.4	
Water, sewerage, etc	3 175	4.1	130.8	30.0	952.5	25.9	821.7	
Construction nec	1 679	9.7	162.5	50.0	839.5	40.3	677.0	
Wholesale trade	5 237	11.3	592.3	30.0	1 572.3	18.7	980.0	
Retail trade	2	5.8	0.1	30.0	0.6	24.2	0.5	
Road transport	939	11.1	104.2	50.0	469.5	38.9	365.3	
Railway transport	5 719	4.0	231.6	30.0	1 715.7	26.0	1 484.1	
Water transport	504	6.3	31.9	13.3	66.8	6.9	34.9	
Air transport	5 706	5.2	296.2	10.0	570.6	4.8	274.4	
Services to transport	1 446	21.3	308.7	50.0	723.0	28.7	414.3	
Communication	11 780	15.6	1 834.7	30.0	3 534.0	14.4	1 699.3	
Non-bank finance	36	42.3	15.2	50.0	18.0	7.7	2.8	
Investment, etc	30	33.3	10.0	50.0	15.0	16.7	5.0	
Business services nec	867	18.3	158.8	50.0	433.5	31.7	274.7	
Public administration	40 522	12.1	4 902.5	32.3	13 097.4	20.2	8 194.9	
Defence	9 301	11.8	1 100.0	30.0	2 790.3	18.2	1 690.3	
Health	11 844	5.8	687.6	30.0	3 553.2	24.2	2 865.6	
Education, museums, etc	11 274	2.0	229.9	10.0	1 127.4	8.0	897.5	
Welfare, religious inst., etc	5 350	2.4	127.0	10.0	535.0	7.6	408.0	
Entertainment & recreation	3 392	2.5	83.9	10.0	339.2	7.5	255.3	
Restaurants, hotels & clubs	35	15.6	5.5	30.0	10.5	14.4	5.0	
Personal services	7	9.7	0.7	50.0	3.5	40.3	2.8	
Totals^c	141 703		11 970.0		35 521.7		23 551.7	

a General government current expenditure and GTE operating expenditure.

b Five estimates in this column do not conform to the ratings of 10 per cent, 30 per cent or 50 per cent for achievable contractable services discussed in the text. These estimates arise from variations in the ratings applied to the expenditure in these industries by different levels of government in the previous tables. For example, the proportion of public administration expenditure to which CTC could conceivably be applied was considered to be greater at the local government level (50 per cent) than at either the Commonwealth or state and territory levels of government (30 per cent). The weighted average of these estimates is 32.3 per cent.

c Columns may not sum exactly to totals as a result of rounding.

Sources: Commission estimates based on ABS Cat. no. 5512.0 (ABS, 1995b), unpublished ABS data and submission information

Table G.10: Estimated government sector share of industry costs

<i>Industry</i>	<i>Government share of industry costs (%)</i>
Services to agriculture	4.0
Forestry & logging	28.0
Fishing & hunting	0.1
Coal, oil & gas	3.8
Meat products	0.7
Milk products	4.7
Commercial printing	0.1
Pharmaceutical products etc	5.5
Non-ferrous metals	10.6
Aircraft	9.6
Electricity	80.0
Gas	20.0
Water, sewerage, etc	85.0
Construction nec	3.5
Wholesale trade	11.1
Retail trade	0.0
Road transport	4.6
Railway transport	91.3
Water transport	18.7
Air transport	64.6
Services to transport	16.4
Communication	70.0
Non-bank finance	0.7
Investment, etc	1.1
Business services nec	1.4
Public administration	100.0
Defence	100.0
Health	50.0
Education, museums, etc	70.0
Welfare, religious inst., etc	65.0
Entertainment & recreation	22.2
Restaurants, hotels & clubs	0.2
Personal services	0.1

Sources: Commission estimates based on ABS Cat no. 5512.0 (ABS, 1995b) and ABS Cat no. 5209.0 (ABS, 1994b)

Attachment G2 The analyses in *The Growth and Revenue Implications of Hilmer and Related Reforms* and this report compared

The main source of differences between estimates published in *The Growth and Revenue Implications of Hilmer and Related Reforms* (IC 1995b) and the analysis in appendix G is the amount of public sector expenditure covered in each study. Results are also affected by differences in the method used to calculate the potential for further CTC and the assumed sources of savings in each study.

Coverage of analysis

In referring to the IC 1995b report, we concentrate on its analysis of contracting in the government budget sector (chapter B3 in IC 1995b). While the effect of contracting in the GTE sector was addressed in other sections of that report, it was addressed in the context of Hilmer and other reforms. This makes it difficult to identify the effect of CTC on the GTE sector in IC 1995b.

The previous IC 1995b analysis covered budget sector *current and investment* expenditures, that is, both current and capital expenditures in the general government section of the public sector. The analysis in appendix G of this report covers *public sector recurrent expenditure* — general government current expenditure and GTE operating expenditure.

Thus, the expenditure coverage in IC 1995b as a proportion of total public sector expenditure in 1988-89 was 48.3 per cent. By comparison, the coverage in appendix G amounts to 86.5 per cent of the total government expenditure in 1993-94 (table G.11). As a result, the coverage of total public sector expenditure in IC 1995b is approximately one half of the coverage of total public sector expenditure in appendix G (ie 48.3 per cent/86.5 per cent).

Table G.11: Public sector expenditures included in each analysis

	<i>IC 1995b</i>		<i>Appendix G</i>	
	1988-89 \$m	%	1993-94 \$m	%
General govt. current expenditure	49 824	41.2	84 357	51.5
GTE operating expenditure	-	-	57 346	35.0
General govt. investment expend. ^a	8 587	7.1	-	-
Total expenditure covered	58 411	48.3	141 703	86.5
Expenditure not covered ^b	62 429	51.6	22 058	13.5
Total public sector expenditure	120 840	100.0	163 761	100.0

a The general government proportion of total government investment expenditure in 1988-89 was 44.2 per cent.

b Not all general government current expenditure was included in the IC 1995b analysis. Furthermore, some general government current expenditure and GTE operating expenditure were excluded from the analysis in this report. Also includes GTE investment expenditure, which was excluded in both studies.

Sources: IC 1995b, p. 137, ABS Cat no. 5512.0 (ABS, 1995b), and Commission estimates based on unpublished ABS data

Further scope for CTC

The estimated aggregate expenditure that can be further contracted in the two studies is shown in table G.12. It shows that the estimated achievable contractable services and services currently under CTC assumed by IC 1995b implied that further contractable services represented approximately 14 per cent of general government current expenditure. In appendix G the figure is approximately 18 per cent. IC 1995b considered that the further potential for CTC in investment activities was 16 per cent of general government investment expenditure but, as explained above, did not consider GTE activity. The study in appendix G indicates only 14 per cent of GTE expenditure is available for further CTC, but has not considered investment activities. On balance, the estimated further potential for CTC on the coverage assumed in the two studies is quite similar. Table G.12 indicates that, in IC 1995b, 14.4 per cent of the activities covered were available for further CTC, while in appendix G, 16.6 per cent of activities covered were available for further CTC.

This shows that the main difference in the two studies lies in the absolute value of government activities covered and the type of government activities covered, as reported in table G.11. While there are also many differences in the analysis regarding achievable contractable services and services currently under CTC, in aggregate the two methods do not result in large differences. From the point of view of economy-wide effects, therefore, differences in results will be largely determined by the different coverage of the two studies, which is very large, and

less so by differences in the achievable contractable services and services currently under CTC estimates, which are small in aggregate.

Table G.12: Comparison of expenditure savings by expenditure type

	<i>IC 1995b</i>			<i>Appendix G</i>		
	<i>1988-89 expend.</i>	<i>Expend. available for further CTC</i>		<i>1993-94 expend.</i>	<i>Expend. available for further CTC</i>	
	<i>\$m</i>	<i>\$m</i>	<i>%</i>	<i>\$m</i>	<i>\$m</i>	<i>%</i>
General govt. current expenditure	49 824	7 033	14.1	84 357	15 416	18.3
GTE operating expenditure	-	-	-	57 346	8 136	14.2
General govt. investment expend.	8 587	1 374	16.0	-	-	-
Totals	58 411	8 407	14.4	141 703	23 552	16.6

Sources: IC 1995b, p. 137 and Commission estimates based on unpublished ABS data

Table G.13 shows the total coverage and total expenditure as determined in tables G.11 and G.12, and the savings assumed forthcoming as a result of further CTC. In IC 1995b this was estimated using a constant savings per unit of contractable expenditure of 20 per cent. The analysis in appendix G employs different estimates of possible savings per unit of contractable expenditure. For ease of comparison, the numbers in table G.13 assume the same potential savings rate of 20 per cent as was assumed in producing table B1.3 in IC 1995b.

Table G.13: Total savings on all government activity assuming 20 per cent savings on contractable expenditure

	<i>IC 1995b</i>			<i>Appendix G</i>		
	<i>\$m</i>	<i>% total expend.</i>	<i>% total cover.</i>	<i>\$m</i>	<i>% total expend.</i>	<i>% total cover.</i>
Total coverage in each study	58 411	48.3	100.0	141 703	86.5	100.0
Total expenditure available for CTC	8 407	7.0	14.4	23 552	14.3	16.6
Savings from CTC	1 681	1.4	2.9	4 710	2.9	3.3

Sources: IC 1995b, p. 137 and Commission estimates based on unpublished ABS data

The total savings as a percentage of total government expenditure is approximately two times greater in the current study than in IC 1995b. This again follows mainly from the difference in coverage. For instance, table G.13 shows that the savings as a percentage of total coverage is similar in both studies — 2.9 per cent in IC 1995b and 3.3 per cent in this study.

Thus, the estimated savings used in IC 1995b amounted to 1.4 per cent of total public sector expenditure for 1988-89. The comparable proportions resulting from the assumptions made in this report are 2.9 per cent (assuming 20 per cent savings on the relevant expenditure) and 1.4 per cent (assuming 10 per cent savings). This difference will be a major cause of the differences in the economy-wide results from the simulations in IC 1995b and appendix G.¹⁸

While the simulations focus on economy-wide results, there will also be significant differences in the individual industry results. These will depend on the size of the changes in each sector, rather than the aggregate economy-wide savings. Thus considerable variation in the effects of CTC at the industry level occurs while aggregate results are quite similar.

The source of savings

The preceding discussion considered only the total dollars of savings in each study. There are also differences in the method by which the savings are assumed to arise. This will imply different outcomes for employment and wages in labour markets. In particular, savings may be due to decreased use of physical inputs or decreased per unit cost of inputs. IC 1995b assumes that all savings occur by:

- decreased unit requirements of labour and capital in fixed proportions; and
- decreased cost of producing investment goods.

In appendix G, cost savings occur in two ways:

- decreased unit requirements of physical units of labour; and
- decreased remuneration to labour.

In both studies, the decreased use of inputs makes those inputs available for other uses, allowing the economy to grow. The decreased remuneration modelled in appendix G is a transfer of income from wage earners to consumers and taxpayers which does not promote growth to the same extent as productivity increases. Therefore, for the same absolute amount of savings, simulations in appendix G will produce lower growth than what was calculated in IC 1995b.

¹⁸ While table B1.3 in IC 1995b was built assuming 20 per cent savings, the economy-wide benefits were modelled using half of the impact implied by that table.

Summary

The effect of the different assumptions discussed above on results are summarised in table G.14.

Table G.14: Effect of differing assumptions on aggregate expenditure^a

<i>Element</i>	<i>IC 1995b</i>	<i>Appendix G</i>
Expenditure amount covered	48 per cent of total government expenditures	86 per cent of total government expenditures
Expenditure type covered	Only general government, but includes investment	General government and GTE recurring expenditures, not investment
Aggregate further contractable expenditure	14 per cent of general government current expenditure; 16 per cent of general government investment expenditure	18 per cent of general government current expenditure; 14 per cent of GTE operating expenditure
Sources of cost savings	All savings due to productivity improvements	Savings divided between two sources; productivity improvements and wage reductions

a Effect on expenditure and growth refers to percentage changes.

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