

Bound for Botany Bay

Contracting for Quality in Public Services

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A Contracting Fable

Over a period of eighty years, somewhere around 160,000 British and Irish convicts were transported to the Australian colonies, almost all of them in ships owned and operated by private contractors.

In *The Fatal Shore*, the classic study of Australia's convict system, Robert Hughes was highly critical of this system of contracting. According to Hughes, the First Fleet of convicts sent to New South Wales in 1787 was 'a government affair from start to finish'.

The results were 'muddled and potentially disastrous', but they were much better than they would have been under private contract. Excluding an outbreak of typhus before the ships left port, 45 convicts and children died in the course of that initial voyage, a death rate of around 3 percent.

By contrast, with the Second Fleet – according to Hughes, the first of the contracted voyages – 267 convicts died at sea and another 150 upon arrival, a death rate of more than 40 percent. One of the survivors recalled that the convicts were confined in the hold for the entire journey and 'were scarcely allowed sufficient quantity of victuals to keep us alive'.

For the ideological opponents of contracting, the lessons of Hughes' comparison are obvious: the private sector cannot be trusted with the delivery of core public services. But in fact, Hughes was mistaken. Both fleets were contractor-operated.

As it turns out, the difference between a death rate of 3 percent and a death rate of 40 percent lies not in who delivers the service but in the design of the contract – the evaluation criteria, the performance regime, and the manner in which the contract is managed.

Evaluation criteria: The contract for the First Fleet was, in essence, a cost-plus arrangement (based on a rate per ton of shipping per month). Given the uncertainty about the length of the voyage and the cost of provisions to be purchased at foreign ports, it is not difficult to understand why such a funding mechanism was adopted.

Cost-plus contracts require close monitoring, and this was provided by the Governor of the new colony, Arthur Phillip, who was more concerned about performance outcomes than cost control. When the final bill came in, the First Fleet had cost around £70 per prisoner, in all, the staggering sum of £55,000 (around £45 million in today's values)¹.

Of course, some of these costs were associated with the establishment of a new colony, but Treasury officials were appalled and when the tender was issued for the Second Fleet in 1789, the Home Secretary instructed that it was to be 'with the least expense to the public'. The new contract was awarded to the lowest bidder, at a fixed price of £17/7/6 per prisoner – less than a quarter of the cost of the First Fleet.

The government had been extremely fortunate in their choice of contractor for the First Fleet. William Richards cared about the way in which the convicts were treated and responded quickly to suggestions from Governor Phillip about improvements to their diet. He was a humanitarian, an evangelical Christian and almost certainly an abolitionist.

But when it came to the Second Fleet, no one inquired too deeply into the credentials of the winning contractor. Camden, Calvert and King were the largest firm of slave traders in London, and they brought with them practices that were not acceptable (even by the standards of the day) for English prisoners being transported half way around the world.

Moreover, no one in the Treasury or the Home Office seems to have understood (or cared much about) the role that reputation could play in ensuring quality outcomes. William Richards belonged to a community that would have judged him harshly if it were known that the convicts were not well treated.

As slave traders, Camden, Calvert and King had no reputation of that kind to protect. The people with whom they mixed may have passed judgement on their commercial acumen, but none of them can have cared much about their humanity.

Contract management: A naval agent was appointed as the contract supervisor for the First Fleet, and the ships' surgeons performed a vital role in monitoring the health of the convicts, but the de facto contract manager was Arthur Phillip himself. Phillip insisted on changes to the prisoners' diet, including the provision of fresh food while they were in port. He instructed the ships to stop three times on the journey out, directing that the prisoners were to be left free of their irons while in the out ports and negotiating to purchase additional food.

By contrast, the contract monitor on the Second Fleet was the naval agent, a relatively junior official and 'an ineffectual hack of questionable competence' (as one historian has described him). He ignored concerns about the quality of the food raised by the ships' surgeons, he was allowed to cohabit with one of the female convicts and it appears that he was plied with alcohol for much of the voyage – an early example of regulatory capture.

For reasons that are not entirely clear, the responsibility for the prisoners was already a matter of controversy while the fleet was still anchored in the Thames. The Army insisted that the convicts were their prisoners and that they would decide whether they were allowed on deck. Supported by the Navy, the contractors argued that they had posted a substantial bond to ensure that prisoners didn't escape, and they must hold the keys. The controversy was resolved by Treasury in favour of the contractors, but relationships remained poor throughout the entire voyage.

Performance regime: We do not have the final contract for the First Fleet, and it is possible that none was ever signed. Performance management was largely left to Arthur Phillip. Undoubtedly, his relationship with the contractor was made easier by the fact that they were operating on a cost-plus basis.

By contrast, the contract for the Second Fleet contained detailed provisions on the standard of accommodation and the level of security. It specified the rations for convicts and soldiers in significant detail. It required the employment of a qualified surgeon, and named a variety of medicines that were to be provided for the sick. The captains were obliged to submit their journals to a government monitor at the end of the voyage. At first glance, this looks like a well-designed contract.

But it also provided extremely heavy financial penalties for escape, with the result that the contractors kept many of the prisoners in heavy slave shackles for much of the voyage. There was no contractual provision as to how many stops were to be made on the way out, but with a fixed price contract, Camden, Calvert and King had a powerful incentive to keep them to a minimum. The principal captain was instructed to proceed 'with all convenient speed' and to stop 'only as you shall find necessary'. As a result, they paused only once, at the Cape of Good Hope.

The captain had also been instructed that he should sell any unused food and supplies at the end of the voyage, 'to the best advantage of our account'. So it is unsurprising that claims were later made that prisoners had been deliberately underfed. As one of the military officers noted during the voyage: 'the more they can withhold from the unhappy wretches, the more provisions they have to dispose of at a foreign market'.

Of the £17/7/6 that was to be paid to the contractors for each prisoner, £5 was paid once the cabins and bulkheads had been fitted to the ships, and another £10 once the stores had been loaded. The remaining £2/7/6 was to be paid at the end of the voyage, when a certificate from the Commissary in Sydney was produced, verifying that the stores had been received. There were no financial incentives whatsoever for the safe delivery of the prisoners.

Undoubtedly, the contract for the First Fleet had its difficulties. There are good reasons why a cost-plus contract should have been used in such an uncertain environment, but the lack of financial targets and strong incentives to ensure that costs were controlled meant that the First Fleet was a very expensive proposition.

But the contract for the Second Fleet was fatally flawed, with tragic consequences for the prisoners. A fixed-price contract was awarded to a low-cost bidder with the wrong reputation and qualifications, and this was undermined by weak contract management and the introduction of performance measures that created perverse incentives.

The death rate caused a scandal in Westminster (although the Navy would insist that the contract had been literally complied with and that poor weather was to blame for the poor health of the prisoners). There was no official investigation and a criminal prosecution failed. Camden, Calvert and King went on to service the Third Fleet, but once the controversy became public, they were not used by government again.

Unsurprisingly, the First Fleet contractor, William Richards, criticised the decision to award the Second Fleet to the lowest bidder: 'Government have rather themselves to blame, for it cannot but be supposed that they are fully capable of knowing at what price contractors can afford to convey [the convicts]'. Richards was subsequently employed for the transportation of two more shiploads of convicts to Australia, with a fixed price contract of £17 per prisoner and a £5 bonus for each one landed alive. On his very next voyage, only one prisoner died.²

It is difficult to think of a more dramatic illustration of the maxim, 'What gets measured gets done'.

Contracting for Quality in Public Services

For much of its history, competitive tendering and contracting have been used by government as instruments for driving down costs. Even the most ideological of opponents acknowledge that they are highly effective at doing that. What they dispute is whether competition delivers value for money. There is now a significant body of evidence gathered over the past two or three decades, indicating that if done well, under some circumstances, competition is capable of delivering a comparable level of service at lower cost.

But as one reviews the history, one is struck by how rarely competition and contracting have been used to drive through service improvement. Indeed, in spite of repeated reassurances that quality will be given appropriate weighting, contractors still

complain that when it comes to the final analysis, evaluation is based overwhelmingly on price. And yet we know that competition and contracting can be used to deliver service improvements, since the UK provides us with several striking examples.

Prisons Management: Contrary to what is often assumed, competition for prisons management in the United Kingdom was not originally introduced to save money. The National Audit Office has explained that 'the main objective was the injection of competition and new ideas', and the fact that the winning tender came in at a lower cost than the Prison Service benchmark was described as 'a pleasant surprise'.³

The Home Office seized the opportunity created by competitive tendering to insist on higher standards – much longer hours out of cell, increased levels of purposeful activity and so on. The Chief Inspector of Prisons for England and Wales has since acknowledged that some of the performance measures laid down for the privately-managed prisons were 'far and above what we find in public sector prisons'.⁴

One important result of this emphasis on service quality is that prison contracting has made a significant contribution to the government's so-called 'decency agenda'. From the very first prison contract in 1992, custody officers wore name tags, inmates were called by their first names, prisoners were given keys to their own cells, and significant numbers of female custody officers were introduced into the prisons for the first time, bringing down testosterone levels and contributing to a reduction in prison violence.⁵

Critics of The Wolds, the first privately-managed prison in the UK, were silenced when prisoners began to speak out in defence of the contractors. John, 31 years old and awaiting trial on a shooting charge, told the press: 'This is the best prison I've ever been in, and I've been in prisons all my life. It's more humane. It's not uptight. The guards are polite.' Prisoners didn't care who managed the prisons, as long as they were treated with respect. It appears that inmates were following the debate closely, since one of them wrote to *The Observer* shortly after The Wolds was opened, rejecting the ideological objections raised by prison reformers:

As someone who is committed to penal reform and as a prisoner, I prefer to adopt a more pragmatic approach to this issue. Today I will spend 18 hours locked in my cell and I will spend tomorrow in exactly the same way. I look with envy at the Home Office tender document for The Wolds privatised remand centre near Hull, which demanded the delivery of a regime guaranteeing a minimum of 12 hours per day out of cell. When Group 4 signed the final document, that figure had been revised upwards to 14 hours.⁷

Given this track record, it is unsurprising that in March 2005, the then UK Prisons and Probation Minister, Paul Goggins, announced the government's intention to market test the management of existing prisons, with the explicit intention of 'driving up standards and encouraging imaginative approaches to managing offenders in custody. . .'⁸

Local Education Authorities: In 1998, the UK Government introduced a programme of inspecting Local Education Authorities (LEAs)* using Ofsted, the Office of Standards in Education. There was to be public reporting of the results and the threat of intervention in those LEAs that proved incapable of

reforming themselves. Of 20 interventions, 11 involved a 'fresh start' driven by the Department for Education and Skills itself; in the other nine, the management of the entire LEA was thrown open to competition from the private sector.

The first comprehensive study of the results of this experiment has recently been published by the Confederation of British Industry. It has found that, on the key performance indicators:

- the nine privately-managed LEAs have improved more than the average for all LEAs in England;
- they have performed better than the eleven 'fresh start' interventions where competition and contracting were not employed; and
- they have improved more than the average LEA with the same low level of attainment in 2000.⁹

While most local authorities have been able to effect cost savings as a result of competing these education support services, this was not the primary reason why the private sector was asked to become involved. And the evidence suggests that competition and contracting have been successful in driving through improvements in educational outcomes.

* A Local Education Authority is roughly equivalent to a school district in North America or a region of a State Department of Education in Australia.

Some Possible Explanations

So if competition and contracting are capable of being used to improve the quality of public services, why have they not been used in this way more often? In the 1980s, after a century or more of pursuing in-house provision, governments in the English-speaking world turned once again to the private sector for the delivery of public services. Since that time, competition and contracting have often been associated in the media with a decline in service standards, reductions in employees' terms and conditions, downsizing of the workforce, a deterioration in the design quality of public assets and the imposition of user-pays. While these criticisms have often been made unfairly, for reasons of ideology or self-interest, in some cases there has been substance to these claims.

For most of these critics (as for Robert Hughes), the underlying reason for this decline in quality is contracting itself, rather than the way in which it has been used. Why have they leapt to this conclusion? Why is it that governments have so often failed to recognise the qualitative dimensions of competition and contracting? Why has the private sector not been used more often to improve the quality of public services? The answer to these questions is no doubt very complex, but there are a number of possible explanations:

Capability: The most obvious reason why private contractors continue to be used by government as its shock troops is that they are very good at it. Competition and contracting are powerful instruments of reform and they are particularly effective at driving through efficiency savings. Politicians are always looking for new sources of discretionary spending, new policies capable of winning the support of new constituencies without offending the majority by raising taxes.

For several decades now, politicians have been able to finance part of this constituency-building through efficiency savings. Using management reform, governments have (apparently) been able to tap new sources of revenue without introducing new taxes or cutting back front-line services. The only constituency that they risked offending were public sector employees engaged in back-office roles; and unlike front-line public servants such as teachers and nurses, this group finds it difficult to generate popular support.

So when the Labour Party discovered on coming to government in Britain in 1997, that it could save around 20 percent on the cost of a new prison by exposing it to competition, they had little choice in a tight spending environment but to abandon their pre-election commitment to bring an end to prison contracting.¹⁰

And when competition in support services is demonstrated to save the US Department of Defence 30 to 60 percent, and contracting air traffic control towers is found to save around 70 percent, it is unsurprising to find that governments from both sides of politics have been talking about 'performance contracting'.¹¹

So if private companies would like to be used by government to deliver better public services, then they need to do more to demonstrate their capability. In the UK, this has begun to happen: the two examples above – prisons and education – are drawn from detailed reports published by the Public Services Strategy Board of the Confederation of British Industry.¹²

Deniability: A second explanation lies in that simple fact that contracting shifts much of the blame for reform to the private partner, a strategy often referred to in the literature as 'plausible deniability'.

Governments have been using the private sector in this way for a very long time: Queen Elizabeth I privately financed privateers such as Drake and Hawkins in their guerrilla war against the Spanish, partly because it enabled her to deny her country's involvement in these provocations.

But we see precisely that same kind of dynamic at work in politics today. Australian politicians have not been able to deflect all of the political opprobrium associated with the introduction of user-pay roads, but surely it is not without significance that *all* of the new generation of toll roads in Australia have been undertaken as public-private partnerships.

Similar confusion has occurred in the UK where some NHS Trusts have reduced hospital bed numbers whilst commissioning new PFI hospitals. This has led some critics of PFI to attribute the reduction in bed numbers to the involvement of the private sector.

Both in Australia and in the United Kingdom, ministers have used the threat of competition as a way of driving public sector reform in the face of internal opposition. They are inclined to portray the threat of competition as inevitable and use the private sector as a 'bogey man' to drive through internal reform. In the UK and in some of the Australian states, there is evidence of this in the custodial sector.

Quality public service companies dislike being used as a stalking horse, because of the damage that it inflicts on corporate reputation and to harmonious relations with staff and unions. And in several recent cases in the UK, companies have made it clear that they no longer wish to play the 'plausible deniability' game.

Measurability: A third possible explanation lies in the difficulty of measuring qualitative reforms. Politicians and public officials find it much easier to justify a decision to award a tender to the lowest compliant bid, than they do to explain qualitative benefits, for the simple reason that cost-savings are easier to measure.

In the UK, the underlying preference for price-based competition is usually explained as fear of the National Audit Office. But the NAO has made it clear on repeated occasions that it does not expect public officials to award tenders to the lowest cost bidder. A better explanation is possibly the highly-charged political environment within which these debates take place and an unsympathetic media that can sometimes make it difficult for senior officials to justify a decision not to award a contract based on lowest price.

But the underlying problem is the lack of robust qualitative measures. In spite of their fundamental importance to the success of competition and contracting, we still lack a rigorous discipline and a published literature around evaluation criteria and contractual performance regimes. It is in the interest of quality public service providers to undertake research in this field and participate in a professional debate about the effectiveness of particular measures.

Credibility: In some cases, this caution about using the private sector for performance enhancement might also be caused by the information asymmetry between customer and contractor that is inherent in complex public service contracts, and the perceived lack of adequate monitoring mechanisms to overcome the problem.

This is George Akerlof's issue in his Nobel Prize-winning essay, 'The Market for Lemons', first published in 1970.¹³ Because of a concern that suppliers know a great deal more about the quality of their services than customers and a fear that, for this reason, contractors will over-promise and under-deliver on the qualitative aspects of a contract, customers tend to retreat to contracting for services which they believe are easier to measure.

Governments might want to use the private sector to provide better quality services, and contractors might wish to position themselves at that end of the market, but this underlying weakness in the management of complex, qualitative contracts results in market failure. There are a number of solutions to this problem: the improvement of monitoring skills, the use of non-contractual incentives, reliance on third-party certification, investment by private firms in a reputation for quality. But in the past, they have been poorly understood by public officials and poorly implemented. Again, there are some indications in the UK that this is starting to change.

Responsibility: The final stage at which the customer has an opportunity to exercise some control over the quality of service delivery is in the monitoring and management of the actual contract. Again, this is an important discipline that is often overlooked.

There is a natural inclination – in the private sector, it seems, as much as the public sector – to assume that once services have been contracted out, they can be managed through light-handed monitoring and the use of financial penalties. Danny Ertel, formerly with the Harvard Negotiation Project and now a consultant specialising in contract negotiation and management, speaks of a large North American utility where the CEO had presided over a massive

outsourcing of corporate services, a contract worth several hundred million dollars. Having signed the contract, the CEO was proposing to appoint a single contract monitor. He was eventually convinced of the importance of managing this contract over time, and the number of contract management staff was subsequently increased to nine.¹⁴

There appears to be an outsourcing mind-set that accompanies competition and contracting – in North America as much as in the United Kingdom and Australia, in the private sector as much as in the public sector – that leads managers to believe that once they have signed a contract, their responsibility for the service is largely at an end.

In the UK and in Australia, there has been a fascination with 'procurement', with far too little attention given to market design and the ongoing management of contractual relationships. Again, there is some evidence that this might be about to change. Partnerships UK, a semi-public body based out of HM Treasury, which has been concerned almost exclusively until now with 'the deal', is presently undertaking a major study of the management of operational PFI contracts.

The customer, not the contractor, is responsible for network design. The customer, not the contractor, is ultimately responsible for network management. At one level, this is a shift in language, but it is much more fundamental than that – it is about changing the whole way in which we view this process of competition and contracting.¹⁵

Believing in the Things We Do

There is some evidence in the UK that contractors are unhappy with being used to deliver cheaper services at the expense of quality. In March 2005, following a television campaign by the 'Naked Chef', Jamie Oliver, several of the leading catering contractors made it clear that they were not interested in trying to deliver nutritious and edible school dinners for 37p a meal.¹⁶

Over the past year or two, the public service companies associated with the Confederation of British Industry have worked with government and unions to create a code of practice to overcome the so-called 'two-tier workforce'. (The unions had complained that some contractors were terminating the employment of workers transferred from the public sector in order to recruit new workers on lower terms and conditions, creating a 'two-tier workforce'.) It is only when the industry makes it

clear that it is both willing and able to deliver high quality public services in an ethical way that governments will more fully engage them in this way.

There is nothing inevitable about a mixed economy in public services. There is no particular reason why this cycle of public service contracting – which for Serco started more than forty years ago – needs to continue for another forty years. It all depends on how well companies like Serco, its competitors and their public sector customers handle this tool of management.

In writing about the private provision of public services, the former Labour politician, Roy Hattersley, has quoted Gladstone on his resignation of the premiership: 'Things are done best by those who believe in them.' It is difficult to disagree with Hattersley. But there is no reason why, given the right incentives, private providers can't believe in public services just as much as government providers.

¹ Based on average earnings and GDP per capita deflators.

² Robert Hughes, *The Fatal Shore*, London: Collins Harvill, 1987; Jonathan King, *The First Fleet*, London: Secker & Warburg, 1982; Michael Flynn, *The Second Fleet*, Sydney: Library of Australian History, 1993.

³ Comptroller and Auditor General, 'Wolds Remand Prison', London: HMSO, 1994; House of Commons, Session 1994-95, Committee of Public Accounts, Sixth Report, 'Wolds Remand Prison', HC 138, 1995, par. 2(xii).

⁴ HM Inspectorate of Prisons for England and Wales, 'Report on . . . HM Prison The Wolds', 1998, p.9

⁵ For a summary of the published research on prison contracting in the UK, see Gary L. Sturgess, 'Competition: a catalyst for change in the prison service', London: Confederation of British Industry, 2003; National Audit Office, *The Operational Performance of PFI Prisons*, HC 700, Session 2002-2003, 18 June 2003.

⁶ 'Inmates find good life in Britain's first private prison', *Agence France-Presse*, 7 February 1993.

⁷ Mark Leech, 'Please privatise my prison', *The Observer*, 9 August 1992, p.18.

⁸ Home Office, 'Raising Standards Through Contestability: Competition to Operate Three Prisons Announced', Press Release, 22 March 2005. At the time of publication, the government had suspended market testing these prisons to give the Prison Service further time to reform, and the status of the market testing policy was unclear.

⁹ Confederation of British Industry, 'The Business of Education Improvement: Raising LEA Performance Through Competition', London: CBI, February 2005.

¹⁰ Contract prisons – Isabelle Park, 'Review of Comparative Costs and Performance of Privately and Publicly Operated Prisons 1998-99', Home Office Statistical Bulletin Issue 6/00, 23 March 2000. PFI prisons – National Audit Office, 'The PFI Contracts for Bridgend and Fazakerley Prisons', 1997; House of Commons Public Accounts Committee, 'The Refinancing of Fazakerley PFI Prison', 26 March 2001, paragraph 26; Justice Committee 1, Scottish Parliament, 'Report on the Prison Estates Review', Sixth Report, 2002, Volume 1, paragraph 181; Mouchel Consulting, 'Alternative Types of Prisons: Final Report to HM Prison Service', March 2000.

¹¹ Defence contracting - R. Derek Trunkey, Robert P. Trost and Christopher M. Snyder, 'Analysis of DoD's Commercial Activities Program', Alexandria, Virginia: Center for Naval Analyses, 1996; Susan M. Gates and Albert A. Robbert, 'Personnel Savings in Competitively Sourced DoD Activities', Santa Monica, CA: RAND, 2000. Air traffic control - Office of the Inspector General, 'Contract Towers: Observations on FAA's Study of Expanding the Program', Report No. AV-2000-079, Department of Transportation, 12 April 2000, Exhibit C.

¹² The Public Services Strategy Board was established by the CBI and a group of leading UK public service providers in 2002.

¹³ George Akerlof, "The Market for Lemons": Quality Uncertainty and the Market Mechanism', *Quarterly Journal of Economics*, 1970.

¹⁴ Private communication with the author. Ertel is the author of an important paper on contracting for quality: Danny Ertel, 'Getting Past Yes: Negotiating as if Implementation Mattered', *Harvard Business Review*, November 2004, pp.60-68.

¹⁵ One of the best expositions of this perspective is to be found in a recent North American book, Stephen Goldsmith and William D. Eggers, *Governing by Network: The New Shape of the Public Sector*, Washington, DC: Brookings Institution, 2004.

¹⁶ The UK Government later announced it was injecting another £280m into school meals, bringing the average cost to around 50p. Tania Branigan et al, 'Kelly passes school dinner test', *The Guardian*, 31 March 2005, p.1.

Serco Group plc

Serco Group plc is a UK-based international service company, with more than 600 contracts in 36 countries around the world, overwhelmingly in the public sector. From its first public service contract forty years ago, providing technical support for the ballistic missile early warning system at RAF Fylingdales in the United Kingdom, Serco has expanded into science and defence, security and corrections, health and education, environment and leisure, public transportation and traffic management. Contracts cover back office support as well as front-line services and range in size from a handful of staff to several thousand.

The Serco Institute

The Serco Institute was established in 1994 as the company's research and policy institute, analysing and sharing best practice in competition and contracting. It serves as a source of ideas and insights derived from an ongoing dialogue with practitioners engaged in service design and service delivery, in the company, in government and in the wider industry. The approach is pragmatic, drawing on Serco's extensive experience in managing change in the delivery of public services.

The Institute launched its publications programme in December 2004 with 'Good People, Good Systems', a qualitative survey exploring what is different about delivering public services under contract. The programme continues with forthcoming publications on contractual performance measurement, the implications of alternative procurement strategies and the design of quality public service markets. With an extensive library on public private partnerships, the Institute will launch its online 'Resource Centre' in the autumn of 2005.

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