

**Just Another Paperclip?**  
**Rethinking the Market for Complex Public  
Services**

A Report to the Business Services Association

by

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31 March 2017

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## Foreword

I welcome this report by Professor Gary Sturgess and thank him for the time and work he has put in to producing it. Gary has a long and distinguished career in this area as a practitioner, thinker, and analyst in this space here in the UK and in many countries around the world.

It is sometime since an in depth look at public procurement and markets was conducted and this report is a timely contribution to the ongoing discussion in this area. It is an independent report and it contains interesting comments and suggestions which will challenge all those involved in the procurement and delivery of public services and projects.

It is not a statement of the position or the views of the Business Services Association and its members - and is all the more interesting for it being independent of a 'corporate' position.

Since 2015 much work has been done to improve the relationship between government and those who seek to partner with it in the delivery of services and projects. This though is an ongoing learning experience for all those involved. It is a continual process of improvement and building on what has been learned.

In any relationship that involves government it is of course the government that is the dominant partner. It is the government that sets the rules, devises the procurement process, makes the decisions, moulds the shape of the market, and awards the contracts. This is as it should be because it is the government, through Ministers, which is accountable to Parliament, and through Parliament to the taxpayer and the voter. Public services and projects are delivered in the public arena, which is what essentially distinguishes them from business-to-business service and project delivery.

Delivering public services and projects is a complicated and challenging endeavour. There are never easy solutions and there are many examples of good partnering and project delivery. There are, of course, examples where lessons need to be learned. This is the responsibility of all those involved, to embrace those lessons, and move forward in a constructive and co-operative spirit.

Mark Fox  
Chief Executive  
The Business Services Association



*'In a meeting with industry, a senior civil servant expressed his view that contracting was suitable for procuring paperclips, but not for complex public services.'*

## Executive Summary

The UK public service market is the most sophisticated in the world. Some other countries have engaged the private sector more extensively in certain sectors, but the UK has undoubtedly been the world leader in opening the delivery of public services to delivery by external providers.

Given the amount of goods and services accessed from external providers, it is vital that government does contracting well. In 2014-15, UK government spent £242 billion – almost one-third of total government expenditure – on external suppliers, compared with £194 billion on staff. Around £100 billion is spent on the procurement of services by external providers.

Of course, public sector employees carry out the most important functions of government – policy advice, financial control, contract management and delivery of the majority of front-line services – but it is clear that the way in which government manages its supply chain is extraordinarily important to the efficiency and effectiveness of public services.

### **Commercial and Political Sustainability**

Over the past five or six years, however, problems have emerged in the UK public service economy, particularly in the commissioning of complex services. A number of high-profile contracts have been cancelled and companies are on notice because of under-performance. Some major contracts are known to be losing money.

A quick survey of the financial returns of five of the largest public service providers reveals that only one has made a commercial return over the past five years. There have been repeated profit warnings, significant revisions of the forward order book, and a sudden increase in the turnover of senior executives. Major international providers are withdrawing from the UK market; companies are no-bidding important opportunities.

There has been a noticeable decline of trust on both sides – questions have been raised about the competence and the integrity of major providers, and suppliers are deeply concerned about the 'race to the bottom' that has been provoked by low-price tenders and the aggressive approach taken by some customers to risk transfer and performance management.

This report was commissioned by the Business Services Association to explore these problems, why they have emerged, and what is necessary to ensure that the market for public services is politically and commercially sustainable.

It is based on interviews with 78 executives from public service companies, political advisers, civil servants and union officials, as well as a close reading of government

reports on procurement and contract management over the past two and a half decades.

### ***What Might be Done?***

Some survey participants took the view that the shift from a relational to a highly contractual market is irreversible, that there is no way of overcoming the loss of trust which has emerged over the past five or six years. The genie could not be put back in the bottle.

Others took the view that markets have cycles, and that the pendulum will eventually swing back to a more relational and trust-based model. This might be true, but the evidence from history and from international markets is that the cycles might be very long.

The alternative view is that the market for complex services is unsustainable if questions of trust are not addressed and more appropriate contractual models are not employed. This was the most widely-held view among survey participants, and it is the approach adopted in this report.

### *What government might do*

The primary responsibility for the political and commercial sustainability of the public service economy lies with government. This is government's supply chain, and if because of the way in which the system is designed and individual suppliers are managed, core public services are compromised and government's brand is damaged, that is ultimately government's fault. Of course, providers must be intimately involved in this process, but there is little that they can do if government does not take the lead.

It is acknowledged that the Chief Commercial Officer has recently begun to address some of the market settings which have contributed to the decline in sustainability. However, many of the issues identified in this report date back several decades, and it is unclear whether the initiatives introduced over the past 12 months will be sufficient to resolve them. If government wants to ensure the survival and development of a diverse public service economy, then it will need to undertake reform of a much more fundamental kind.

### *Recommendations*

Government must formally acknowledge at the highest level that the procurement and contract management tools appropriate for buying 'paperclips' – highly commoditised, easily specified goods and services – are not appropriate for commissioning complex support services and front-line human services.

Policymakers must distinguish between those markets that have developed to the point where they are capable of commoditisation, and those where the complexity of or uncertainty about the services in question and/or a general lack of understanding or expertise on the supply side requires a less transactional approach.

If the market for complex public services is to survive and mature, it is essential that government work with industry to rebuild personal, organisational and institutional trust.

With this in mind, government should consider a separation of its responsibilities as market steward from its role as customer.

To begin the process of trust-building, government and industry leaders might be brought together to concentrate on resetting market conditions in just one or two sectors. These would serve as small-scale experiments for exploring different ways of resolving the problems, and by focusing on only one or two sectors at once, senior executives on both sides could be involved. If such a process were to succeed, it will require careful design and management.

Public officials must recognise that, for a time at least, companies may be induced to act against their medium- to long-term interests in competitive tendering. Concerns about profitability and corporate brand will not necessarily act as a brake in aggressive price-based procurements. This is one of those issues where the private sector has very little to contribute – it is government's responsibility to understand the reasons why procurements so often favour the lowest price over value-for-money, and to introduce systems and processes to compensate for the bias.

Consideration should be given to reinvigorating the discipline of commissioning within central government. Done well, commissioning can be a powerful instrument in challenging the optimism bias and systemic self-deception which often characterises complex projects and procurements. This is not to say that there will always need to be a separate commissioning agency, but it is fundamental that there is a distinct function (and hopefully, a recognised discipline).

Consideration should be given to the establishment of a centre of excellence for the study of applied public service contracting, and the design and operation of public service markets. This would work best if it was funded jointly by government and industry, and there was a clear commitment to the centre's independence and longevity. The objective should be to undertake detailed research into real-world markets, contracts and procurements, extracting the lessons without laying blame. For such an institution to work, it would need to enjoy the absolute trust of both government and industry.

If government is serious about improving capability in market design and stewardship, and in commissioning, procurement and contract management, it must give serious attention to the study and teaching of these distinct disciplines. There are precedents. The Major Projects Leadership Academy, based at the Saïd Business School at the University of Oxford, has quickly acquired a reputation for excellence. The US Defence Acquisition University is another possible model.

#### *What industry might do*

There are limits to what the industry can do to contribute to this process. This is government's supply chain, and government must decide the rules and the conventions that will govern these markets: if departments and agencies engage in

aggressive gaming, they should not be surprised if providers do likewise. And because of laws which preclude collaboration among firms in bidding for contracts, there are constraints on the extent to which industry can respond collectively.

Individual companies must decide for themselves, independent of their competitors, how they will respond. But there are things that can be done at an industry level which might be of benefit to individual providers.

### *Recommendations*

Structured conversations can take place amongst commercial rivals without infringing the bounds of law or propriety – using data clubs to share information about performance; engaging through anonymous and independent structures and processes, to construct a disinterested and balanced account of market conditions; developing a framework by which providers can conduct their own due diligence assessment of potential customers. This is about building a shared understanding of the market, how it works, the different ways in which companies might respond, and the likely consequences of different responses.

Industry must find new ways of telling its story. Ministers and civil servants will not defend contracts that have become controversial, no matter how well they have performed in the past. Industry must develop the narratives that will assist the politicians, the public servants and the public to appreciate the contribution.

In particular, there is a need to explain: the important contribution of the service sector in the national economy, and particularly the public service sector; the role that profit plays in the economy, particularly in stimulating innovation; the important functions performed by those involved in the day-to-day delivery of services; and the part that good management can play in better public services.

### ***What Has Happened and Why?***

There have been a multitude of reports and guidance documents over the past two or three decades which have repeatedly addressed the same broad concerns about procurement and contract management. Rather than covering the same ground, this report seeks to understand the underlying conditions that are necessary for market sustainability.

### *Auctions and Austerity*

Competitive tendering is a highly effective instrument for driving down price: no one disagrees with this proposition. Concern over the use of this instrument has always focused on the way in which an intensive focus on price encourages a ‘race to the bottom’, compromising quality of service, workers’ terms and conditions, corporate profits and, potentially, the political and commercial sustainability of the market.

Over the years, providers have repeatedly pleaded with government not to employ aggressive price-based tenders for complex public services. Experienced players know that it is difficult for them to abstain from bidding if their competitors persist. They also understand the impact that low-price competition will have over time on relations

with their government customers, the public at large, staff and unions, and investors and analysts.

In spite of repeated warnings over several decades about the dangers of low-price bidding for complex services, the problem is worse now than ever.

Several providers interviewed for this report described tenders where price and quality were meant to be balanced but where, because of the structure of the assessment process, the procurement wound up being assessed solely on price. It was not unusual, they said, for potential customers to speak about quality and innovation in the early stages of the procurement, but then to focus almost exclusively on price.

The National Audit Office has provided examples where suppliers have signed contracts that reduced prices by 25-30% for services that had already been market-tested several times. This is madness – in the absence of some major technological breakthrough, no provider can hope to deliver real productivity savings of this scale over the short-term, particularly with a service that has already delivered significant cost savings.

Self-interest may not act as a constraint on self-harm in an aggressive price-based procurement, and there are a number of reasons for this. Company executives are human beings, subject to the limitations of the human condition, and they are often obliged to make decisions with little time, drawing upon limited information. But there are also cultural and systemic reasons for such behaviour – sunk costs, a perception of first mover or last survivor advantage, unexpected changes to customer behaviour in a sudden shift from relational to transactional contracting, the bias to deal-closure embedded in bid teams, the inclination even amongst operational managers, to become caught up in ‘bid fever’, investor expectations of growth.

While the imperative to reduce costs in a time of austerity has undoubtedly contributed to the use of intensive low-price bidding among departments and agencies, the bias in favour of price has long been a feature of public sector procurements. In part, it seems to be an issue of risk aversion. As one survey participant expressed it: ‘No one ever gets fired for going with the lowest price’. Another former civil servant said that while budgetary issues are today’s concerns, ‘value is seen as jam tomorrow’.

There does seem to be a view in central government that procurement teams are not responsible for rejected tenders that they believe to be unsustainable. One senior civil servant involved in the commercial service told the author that, in his view, if two bidders persisted in offering exceptionally low prices, he felt obliged to accept the lowest, even if he believed that it might be unsustainable. It has not always been so.

### *Aggressive Risk Transfer*

Industry is gravely concerned at government’s attempts to transfer risks which it is not able to manage – the NAO has acknowledged this as an issue, but it has not yet been recognised as a whole-of-government problem. Risk transfer was mentioned more often than anything else by survey participants as they sought to describe the current state of the market. Again, this is not a recent problem, but it has become much worse in recent years.

Contrary to the longstanding policy of government, recently restated in the 'Government Commercial Operating Standards', that 'risks are allocated to the parties best placed to manage risk', the experience of recent years has been that procurement teams are aggressively seeking to maximise risk transfer.

Several of the larger providers said that this was a significant reason why they were now qualifying out of more procurements. One chief executive said that they had withdrawn from an entire market sector because of a shift to unlimited liability.

The kinds of risk which companies are expected to bear are varied – policy risk, state-aid risk, unlimited liability, excessive performance bonds, break clauses without costs, responsibility for ensuring cooperation with other government agencies, long-term capital risk in short-term contracts, and the risks associated with an incomplete understanding by the customer of the nature of their services.

Why have companies assumed these risks? The best explanation seems to be the shift within government from a relational to a transactional approach to contracting – based on years of previous experience, company executives did not believe that government would interpret such clauses strictly.

### *Market Models*

One of the most important insights from this study is the need for government and industry to recognise that the procurement and contract management tools that are appropriate for buying 'paperclips' – highly commoditised, easily specified goods and services – are not appropriate for commissioning complex support services and front-line human services.

The shift from a relational form of contracting, based heavily on personal relationships and institutional trust, to a highly transactional approach, which relies on the enforcement of performance indicators through financial penalties, is based in part on the failure to understand this distinction.

It appears that there is scope for a one-off financial gain when the dominant party in a market suddenly shifts from a relational form of contracting to an aggressively contractual one. Arguably, this is what happened in the UK market over the past five or six years. Government has exploited its supply chain, extracting large cash payments based on the promise of additional business, adopting an adversarial approach to the interpretation of contract clauses and in the process extracting significant financial abatements or penalties in circumstances where, traditionally, a more collaborative approach would have been adopted.

Contract form must follow service function – and if government is not willing to adapt its contracting models so that they are appropriate to the services being put to market, then the range of functions included in the contract will inevitably shrink. Highly transactional contracting forms are appropriate for simple functions but not for complex services.

A move in some parts of government and industry to commoditise the market is another example. There has been a view in government that 'significant and substantial savings can be achieved through centralisation, aggregation and

standardisation', while providers have sought to reduce their prices and (for a time) increase their margins, through 'step and repeat'.

The danger is that if government treats complex public services as commodities when they are not capable of being standardised, this will encourage a focus on price and a race to the bottom. There are examples of e-auctions being used for complex public services, with providers being caught up in bid fever as a result.

Government has two roles when it comes to the design and operation of public service markets: it is both a player in the market and the regulator, with the responsibility for ensuring that the various parties play by the rules. There is potential for a conflict of interest between these two responsibilities, and if it is not addressed, government-as-customer may change the rules to the disadvantage of its suppliers, who will be unprotected by government-as-regulator.

One of the consequences of this radical shift in government's approach to contracting has been a loss of trust. Government has lost confidence in the integrity and the capability of providers, and there has been a decline in trust for the institution of contracting itself. But at the same time, the industry has lost faith in government. This began with the decision by government in 2010 to extract large cash payments – hundreds of millions of pounds – from its major providers with no legal or contractual foundation. The content of these conversations has never been disclosed, but the chief executives who were called to these meetings certainly understood that their standing with government would be affected by their willingness to cooperate.

Such practices are sometimes used in the private sector, but they are regarded as a particularly aggressive way of managing a supply chain, and courts and competition regulators have taken the view that they are an abuse of bargaining power and 'unconscionable conduct'. There is no question that this behaviour shook the industry and compromised the trust relationship that had built up over the years.

Trust is a form of social capital – in commercial relations, it provides 'order for free' (or at least at a substantial discount). When trust is lost, customers and suppliers must invest more in systems and processes that can serve as substitutes: survey respondents reported that negotiations are now more often dominated by lawyers and compliance experts, rather than people concerned with operations. One participant reported that his company was now sometimes appointing lawyers as contract directors. It does not require a deep understanding of the delivery challenges faced by the human service providers to know that this is not a desirable outcome.

### *Systemic Self-Deception*

There is a significant amount of evidence, collected over many years, that departments and agencies struggle to maintain a sense of proportion when it comes to major projects and procurements. One example of this problem is the temptation of ministers and civil servants to set unrealistic timescales for large procurements. Another is the practice of signing legally-binding agreements when the tasks which the contractor will be required to perform have not yet been resolved.

These are fundamental failings, and they have been often identified by the NAO and other government inquiries over many years. Their recurrence in major contracts in recent years should be a matter of grave concern to government.

To some extent, this is the problem of optimism bias, now well-recognised (although not always overcome) in the planning and execution of major projects. But there is more to it than that – it seems that the adversarial nature of the procurement process and the creation of a strong organisational boundary between commissioner and provider also plays a part.

When it is done well, contracting obliges commissioners and delivery agents to clarify the intended outcomes of the service in question, and the resources (people, money and time) that will be required to deliver those results. This is the core principle on which the discipline of commissioning has been built – commissioners are not only given a range of levers to ensure that the hand-off from policy (and funding) to delivery is managed well, but they are also provided with a place to stand. It is as much a question of authority as it is of capability.

When commissioning and procurement are done badly – in circumstances where there is only weak authority or incentive to challenge – the contractual boundary serves to magnify the self-deception (on both sides). And of course, in a market where there is little trust and where both sides are gaming the system, the boundary becomes a conflict zone. This is not primarily about the public-private divide, but rather an extreme version of the traditional differences between policy and delivery.

#### *Continuity, Capability, Authority*

Survey participants are frustrated at the high rate of churn among civil servants – they no longer expect that there will be continuity on major procurements or throughout the life of a contract. This is yet another issue of long standing. One of the consequences is a lack of experience and competence. It is not unusual for external advisers to be the custodians of corporate memory. A second implication is that there is less accountability for results – one participant referred to it as a game of ‘pass the parcel’ – the medium-term consequences of a decision (or non-decision) are someone else’s problem.

There has been renewed focus in the past couple of years on building the commercial capabilities of government. This is welcomed in the industry, although it has been identified by government inquiries over so many years, that suppliers are not yet reassured that a fundamental shift has taken place. But this focus on so-called commercial capabilities is both too narrow and too broad. There are a number of different disciplines necessary for the effective stewardship of public service markets – commissioning, procurement, contract management and market design and management.

## Introduction

The UK public sector spends more through contracting than it does on providing services itself. In 2014-15, government spent £242 billion – almost one-third of total government expenditure – on external suppliers, compared with £194 billion on staff.<sup>1</sup>

Of course, the majority of this is spent on the purchase of highly-commodified goods and in the construction of public facilities, but according to the NAO, around £100 billion is spent on the delivery of services by external providers.<sup>2</sup> The available evidence suggests that the proportion of expenditure on non-employee costs is higher in local government.

Public sector employees carry out the strategic functions of government – policy advice, financial control, contract management and delivery of the majority of front-line services – but it is clear that the way in which the public sector manages its supply chain is extraordinarily important to the efficiency and effectiveness of government.

Private and not-for-profit providers have long played a role in the public sector, but the scale and complexity of public service contracting has grown significantly since the introduction of compulsory competitive tendering in local government and the NHS in the late 1980s and early 1990s. Successive governments have expanded the role of external providers in the delivery of business support and front-line services.

As a result, the UK public service economy is today the largest and most sophisticated in the world. Some other countries have engaged the private sector more extensively in certain sectors – Australia and the Netherlands in education, France and Germany in healthcare, Denmark in emergency services – but unquestionably, the UK has been the world leader in opening the delivery of public services to delivery by private and not-for-profit providers.

However, the past five years have seen a radical transformation in the way central government engages with its supply chain, with ministers driving a process of standardisation and centralisation, pushing out the boundary between public and private, and actively using competitive tendering to drive down price.

At the same time, there has been a noticeable decline of trust on both sides of the market – questions have been raised about the competence and the integrity of major providers, and suppliers are deeply concerned about the ‘race to the bottom’ that has been provoked by low-price tenders and the aggressive approach taken by some departments and agencies to risk transfer and performance management.

Industry has become increasingly concerned about the health of the market under such conditions, particularly for complex and front line services. This report was commissioned by the Business Services Association, the industry body which represents companies involved in the provision of public services, to reflect upon the conditions that are necessary for political and commercial sustainability.

The focus is on what *government* might do to improve the state of the market. This is for two reasons: (i) providers are prohibited from collaborating in bidding for government business, so there are severe limitations as to what they can do to correct these problems; and (ii) this is government's supply chain, and ultimately, it is government that will be held responsible for the outcomes.

### *Methodology*

Not-for-profit providers and social enterprises make up a significant proportion of the public service economy, but given timing constraints, it was decided to confine the project to the for-profit sector, in particular the providers of complex services.

The author conducted 78 interviews over four weeks in October and November 2016, most of them with the executives of 24 large and medium-sized providers and four advisory firms involved in the UK public service economy. These included 12 current and two former chief executives and 20 current and former senior executives. Three of the companies were selected to interview more junior personnel responsible for bidding and operations, commercial and financial control. Seventeen of the private executives had worked in government, in the UK or overseas, earlier in their careers.

Seven current and former civil servants were interviewed, four of whom have or have had high level responsibility for procurement and contract management. Approaches were made to a broader range of public officials, but it proved difficult to obtain access in the time available, and it was recognised that, as serving public officials, they would have been constrained in what they could have said. Conversations were also held with four former ministerial advisers, one member of parliament and a union leader, all with long-term engagement with the industry. (A number of women executives and officials were interviewed, but to ensure anonymity, masculine pronouns have been used throughout this report.)

This is not a representative sample, but the author was able to have frank off-the-record conversations with senior executives across a range of different enterprises with different service offerings and different business models.

As a result, the report provides rare insights into the attitudes and the experiences of senior executives of the industry, most of them with long experience in the sector. A number of survey participants were extremely frank about the financial position of their companies and the mistakes they had made over the past few years. Some of these sentiments have no doubt been expressed to government at different times, but if so, they have not been made public.

The author also studied dozens of NAO and other government reports on procurement and contract management going back to the early 1990s. Apart from the resources available online, he was able to draw on his own archives of government reviews in which he participated and meetings he attended over the period 1995 to 2011.

### *The Author*

The author is a former Cabinet Secretary in the state government of New South Wales (NSW), Australia, who spent seven years as a non-executive director of Serco Group plc (1993-2000) and eleven years living in the UK (2000-2011) for most of that time as the executive director of the Serco Institute, a think-tank funded by the Serco Group.

In 2002, he helped to establish the Public Services Strategy Board of the Confederation of British Industry, the first industry association in the UK representing companies specialising in the delivery of public services. He served as a board adviser from its establishment in 2002 until his return to Australia in 2011, working with chief executives across the leading public service companies, and participating in meetings across a wide range of departments and agencies.

Professor Sturgess severed all ties with Serco in early 2011 and returned to Sydney. He now holds the NSW Premier's ANZSOG Chair of Public Service Delivery at the University of New South Wales. The Australia and New Zealand School of Government (ANZSOG) is collectively owned by the national and state governments of Australia and New Zealand, and has working partnerships with sixteen universities. He is also Professor of Public Service Innovation at Griffith University in Brisbane, Queensland. He has chaired a number of government inquiries for the NSW government, and has served on government boards, councils and committees across the three eastern states.

He was a guest lecturer for several years at the UK Commissioning Academy, teaches a commissioning academy once a year in Ontario for the Institute of Public Administration Canada, and advises the New Zealand government on commissioning for outcomes.



## 1. The State of the Market

### 1.1 Commercial Sustainability

No one who follows the news media would disagree that public service providers have been through several tumultuous years. Following controversy in 2013 over several contracts managed by the Ministry of Justice, two large providers were precluded from bidding for a time, and agreed to pay the government more than £170m by way of settlement.<sup>3</sup> The national focus on austerity has resulted in competitive tendering being actively used to drive down prices, with the fees being paid for some mature contracts reduced by 25-30%. At the same time, there has been an aggressive focus on risk transfer, with some companies being obliged to accept responsibility for policy and performance risks which they say they are unable to manage.

A number of high-profile contracts for front-line services, facilities management and ICT support with the NHS, the Department for Work and Pensions, the Home Office and the Ministry of Defence (among others) have been cancelled or are on notice due to under-performance, and other major contracts are known to be losing money.

A quick survey of the financial returns of five of the largest public service providers reveals that only one has made a commercial return over the past five years (and in that case, the situation is obscured by returns from private sector business).<sup>4</sup> Over the second half of 2016, two of the largest providers issued repeated profit warnings, while others significantly revised their estimates of the forward order book.

After years of continuity in the senior management ranks of the large public service providers, there has been a sudden turnover to new entrants from outside the sector, in some cases, at the insistence of government.

It is difficult for casual observers to form a clear view as to what has been going on – for obvious reasons, none of the players (government included) is capable of taking a balanced position, and neither side benefits from having the current state of the market portrayed ‘warts and all’.

One explanation is that the industry had been charging excessive prices on some of their contracts in the past. In some quarters, the fact that companies have signed up to such large price reductions was seen as evidence that competition had not been driven hard enough. It has been argued that government had not been extracting full value from its supply chain because it was uncoordinated in its procurement strategies, it had ceded too much decision-making authority to a handful of large suppliers, and it had failed to standardise contract conditions.

There has been a renewed emphasis on contract management, with a particular focus on the commercial capability of departments and agencies. Performance criteria are being managed more intensively, and the revenue from financial penalties has increased significantly as a result.

Given the financial state of the industry – evidenced by the annual accounts and newspaper reports about the larger companies – the question is now being asked whether these reforms have not gone too far. For obvious reasons, the industry has found it difficult to develop a coherent response to these reforms: different companies have different business models, and the chief executives of large corporations are reluctant to speak out, from a concern that they might cause offence to their customers. When Rupert Soames, the chief executive of Serco, uttered some highly-guarded remarks in November 2016, eyebrows were raised across the sector:

The fundamental truth is that working with government is really laborious; it's really cumbersome. They have absolutely fiendish terms and conditions; bidding for work is really difficult. It takes ages. The whole tendering process is very complex – and it has to be, because it's with public funds.<sup>5</sup>

As the author spoke with industry leaders in private, a broadly consistent narrative began to emerge. While different companies have responded in different ways, there is widespread concern at the impact that low-price bidding has had on service quality and financial sustainability. Providers are exasperated at procurement teams who insist on the transfer of risks that simply cannot be managed by providers. They are angry at the aggressive behaviour of some customers who seem to regard financial abatements as an alternative source of revenue.

The following comment, by an experienced senior executive from a large international supplier, is typical:

The market is certainly tightening. It is more cost-focused, with winning based more heavily on price. Quality matters, and over the last three years, there have been fewer of those opportunities around.

Survey respondents acknowledged that by continuing to participate in low-price bidding, and taking on risks they could not meaningfully manage, the industry has encouraged aggressive behaviour on the part of some government customers.

The precedent was set by the Cabinet Office following the global financial crisis, but other departments and agencies have continued to pursue a highly aggressive strategy in negotiating with companies, both in the negotiations prior to signing the contracts and in the negotiations prior to early exits.

This experience is by no means universal, and most providers had positive things to say about some of their customers. They acknowledge that over the past year or so, the Crown Commercial Function (as it is now called) has begun to adopt a more balanced approach to contracting. In recent months, a number of policy notes and guidance documents have been released by the Crown Commercial Service which reflect a more mature approach to procurement and contract management. The Mystery Shopper reports published by the Crown Commercial Service show a decline in anonymous complaints from small suppliers since 2014.<sup>6</sup>

But there is still deep disquiet among the large public service providers and, thus far at least, it seems that these changes have not extended down into procurement teams. Survey respondents are unsure whether these changes will persist.

There is one sector where there is clear evidence of the impact that severe budgetary constraint and a lack of market stewardship can have on commercial sustainability: social care, with some of the leading providers making substantial losses and walking away from the market. A 2015 survey by the UK Homecare Association documented the decline in provider confidence in the home care sector:

- 93% of providers trading with councils had faced a real-term decrease in the price paid for their service over the previous 12 months, and 20% reported a decrease in the actual fees paid;
- 50% of providers who were aware of tender opportunities from their local authority had declined to bid on the basis of price;
- There was strong evidence of pending market instability over the next year: 74% of providers trading with councils said that they would reduce the amount of publicly funded care they delivered, estimated to affect 50% of all the service users they support; and
- 11% of providers thought they would have 'definitely' or 'probably' ceased trading within the next 12 months, while 38% of providers were completely confident that they would still be trading at the same time next year.<sup>7</sup>

A similar situation exists in the residential care market. In its 2016 'State of Care' report, the Care Quality Commission stated:

Our data shows the severe financial strain that local authority funded providers continue to be exposed to. Care home providers with more than half of their turnover funded by local authorities achieve, on average, 10% less fee income per bed and generate almost 28% less profit per bed, compared with all providers.<sup>8</sup>

There is widespread concern about the quality of service in the home care sector. There have been reports of workers being paid less than the minimum wage. At the same time as the large regulated providers have been losing substantial sums of money, there is resentment over profit. And there is ongoing speculation that many of the larger companies will withdraw from the market, leaving services to be provided by large numbers of small unregulated providers.<sup>9</sup> The recent decision by Mitie to dispose of its home care business at a loss of almost £140 million, confirms the difficulties being experienced by investors in this sector.<sup>10</sup>

This is broadly consistent with the challenges being faced by the rest of the industry, particularly in the markets for complex and front-line services.

## 1.2 Political Sustainability

In times of severe financial stress, it is understandable that governments will feel the need to significantly reduce public spending. However, it is politically difficult to cut front-line services, and governments usually prefer to retrench policy capability and management overheads, defer repairs and maintenance, reduce support services, increase workloads and shade service quality. If public service contracting is employed to deliver these sorts of initiatives, then it is inevitable that it will suffer by association.

Competitive tendering is a highly-effective way of driving down the cost of a service to government, and in the short- to medium-term, this may appear to offer a convenient solution. But if providers sign up to outcomes that are undeliverable and/or if they agree to prices that are unsustainable, they may disappoint customers by providing services of lower quality and reliability and/or they may disappoint shareholders and investors by delivering unacceptable returns, causing them to surrender their contracts early. In either case, this may result in individual companies losing the trust of their customers (and the public at large), and ultimately it may contribute to a loss of confidence in public service contracting overall.

Private providers are usually involved in delivering support services, and in times of austerity, when these are targeted for greater retrenchment, contractors will find themselves at the cutting edge of controversial reforms. In particular, public service contracting may come to be linked in the public mind with low-price bidding and a 'race to the bottom': a senior union official observed in the course of this review, 'outsourcing is now inextricably linked to austerity'.

Public service contracts (which usually fund specified outputs) are less flexible than direct delivery (which has traditionally funded capability), and the consequences of unsustainable cost reductions tend to be apparent more quickly. In a highly changeable policy and funding environment, departments and agencies will be tempted to reduce the duration of contracts, making it more difficult for suppliers to make appropriate investments and deliver organisational transformation in realistic timeframes.

In times of austerity, there will also be less tolerance for corporate profits. Governments still have to cover the cost of capital and to compensate for the risks associated with innovation, even when services are delivered in-house, but these costs are much more obvious and much more difficult to justify when services are delivered by private providers.

It seems likely that each of these factors has contributed to a loss of confidence in public service contracting amongst politicians and civil servants. While there is no hard evidence to support it, a view has developed in government that public service providers were systematically overcharging. There is a view that 25-30% price reductions on mature contracts are sustainable and there is a reluctance to believe suppliers when they report that they are losing money.

There was deep disappointment in government when it was discovered that several large suppliers were charging for services not actually delivered (even though it would seem that some contract managers in government had long been aware of the arrangements). There is growing concern at the number of contracts where providers are failing to deliver what they have promised.

### 1.3 A 'Gresham's Law'?

The question which this review was asked to address is whether the current settings are sustainable, politically and commercially, for complex and front-line services which are at the cutting edge of market development, and attract the most attention in parliament and the press.

Again, it is difficult to obtain hard evidence, but there is no doubt that, over time, the reputational and financial damage caused by underperforming contracts, and the dissatisfaction caused by aggressive procurement and adversarial contract management practices must have an impact on market confidence. The NAO commented on this effect in its 2016 review of the Department of Work and Pensions' contracts for health and disability assessments. One experienced bidder withdrew from this procurement because the department would not listen to concerns about the targets for assessments and the company concluded that it could not meet the department's numbers:

A Departmental review found that tight procurement timetables, inflexibility towards critical assumptions, and lack of transparency risked damaging market interest. . .

The NAO recommended that DWP 'should increase activity to engage providers in learning lessons from recent experience, and to understand barriers to providers bidding for and providing assessments'.<sup>11</sup>

There have been numerous examples of this behaviour over the past few years, and many providers have found it difficult not to play. One of the participants in the survey for this report acknowledged:

The evidence of the past few years has been that you could beat companies up and they would take it.

For reasons that are explained in the next chapter, companies failed to understand quickly enough that the contracting environment had shifted from a relational approach to a highly transactional one. And for a time, they felt that they had no alternative but to participate in low-price procurements and to take upon themselves unmanageable risks.

Based on the comments of survey participants, it would seem that companies are now being more selective. They are no-bidding contracts more often. They have improved internal governance in an attempt to constrain 'bid fever'. They are refusing to accept unmanageable risks, even if that means being disqualified for submitting a non-compliant bid (and thus wasting the millions spent on bidding).

Of much greater concern is the fact that some companies are questioning their commitment to the entire market. Since 2013, G4S has reduced the share of government business in its portfolio (around the world) from 24% of global revenue to 14%. This represents a significant withdrawal of management capability from the public service economy, in the UK and overseas.<sup>12</sup> A senior executive in the London office of a global provider said that ministers and civil servants did not understand that, viewed from head office, government is seen as having a 'difficult investment dynamic' and not worth the pain. He has had to defend their commitment to the UK market.

One chief executive said that there was a lack of respect for industry and a legacy of distrust. Relationships had become antagonistic and adversarial. Board members had expressed the view that: 'If a private company treated us that way, we wouldn't do business with them again'.

The director of a British company which has had considerable success in expanding overseas said that there is now more scrutiny of local bidding and operations at board level: they want to be reassured that they are not at risk reputationally. Another international provider compared their recent experience in the UK with a current procurement in another European country where there has been early engagement with industry and intelligent use of competitive dialogue, with the next year to be spent building the model, reaching a common understanding about objectives, shaping the contract and identifying risks. This was offered as an alternative to the adversarial approach to contracting currently being employed in the UK.

Some ministers and civil servants have taken the view that there is a deep pool of potential providers from which to draw – one chief executive of a large corporation recalled being invited by two ministers to submit a bid for a major multi-contract procurement. When he explained that the market was, in his opinion, poorly designed, he was told that government did not need them anyway – there was a surfeit of potential suppliers wanting to bid. With such an attitude, it is unsurprising that public officials have been reluctant to listen to warnings from experienced providers.

In the short term, government was able to deepen the supply side by drawing in more foreign companies, encouraging suppliers to broaden their service offerings beyond their traditional competencies, insisting upon joint ventures with not-for-profits and public service mutuals, and awarding contracts to government-owned corporations and social enterprises underwritten by government.

However, the costs of entry into a new market are high, particularly for the delivery of complex public services, and if government adopts an adversarial approach to its suppliers, and companies find it difficult to make a reasonable return, then the effect on the supply side will be obvious.

For a time, some companies may bid in the hope that they will be the last standing in the field, and for a time, the government may attract new entrants, but increasingly it will become a game of chicken, and something akin to Gresham's Law will emerge. High risk takers will win contracts at the expense of more prudent companies. Bad contracting will drive out good contracting. Ultimately, this will not be sustainable either, at least not for complex services.

If government intends to continue delivering public services through a diverse and contestable supply chain, it must engage the market to understand why experienced providers are no-bidding procurements and having difficulty in delivering their contractual commitments. This report was commissioned by the industry as a contribution to that process.

## 2. What Has Happened & Why?

If government is to feel confident about using contestability to challenge performance and drawing upon a diverse supply chain of public, private and not-for-profit providers, then the market must be well managed. For the long-term survival of the market, it is vital that there is broad support among the general public, among politicians and public servants, and among suppliers, both management and staff. In short, the mixed economy that has emerged in the UK for the delivery of public services must be politically and commercially sustainable.

There has been a vast array of government reports and guidance documents published over the last two or three decades – by the National Audit Office, the former Audit Commission, the former Office of Fair Trading, parliament committees, departmental reviews, independent inquiries and think tanks – which explain how market design and stewardship, procurement and contract management should be done, and the absolute necessity of building government capability.

And while there has certainly been some improvement over time, in far too many areas, this advice has been ignored. As the following discussion makes clear, the same fundamental mistakes are still being made a quarter of a century after they were first raised.

There is no need for another guidance document which explains the multitude of procedures and processes that are necessary for good procurement and contract management. Instead, this document focuses on a handful of cultural, structural and constitutional issues that are so fundamental that no market for complex public services can survive long without them.

### 2.1 Auctions and Austerity

Competitive tendering is an extraordinarily powerful tool for driving down price. Absolutely no one disagrees with this proposition.

Rather, the debate over the use of competition in selecting the providers of public services has always focused on the way in which intense tendering based heavily on price encourages a ‘race to the bottom’, compromising quality of service, workers’ terms and conditions, corporate profits and ultimately the political and commercial sustainability of the market.

This was the experience with the compulsory competitive tendering regime established in UK local government and the NHS in the late 1980s and early 1990s. One study of CCT in local government found that procurements which attracted a larger number of bids (and thus were more intense) were associated with lower levels of compliance, presumably because the winning bidders were more likely to submit unsustainable prices in order to win.<sup>13</sup> A study of hospital cleaning contractors under CCT concluded:

From more than fifty firms expressing a serious interest in tendering over the period from 1984 to 1990, it is doubtful if more than a handful came out of that experience in net profit over this seven-year period.<sup>14</sup>

This tendency to a 'race to the bottom' was one of the principal reasons why the unions were so strongly opposed to CCT, and why the Labour government replaced it with 'Best Value' when it came to office in 1997. A senior union official told me in the course of this survey that CCT had poisoned outsourcing from the outset. In this sense, the CCT market had become politically unsustainable.

But it was also commercially unsustainable. By the early 1990s, companies that understood the importance of attracting and retaining high-quality staff began to withdraw from the market, and number of experienced providers welcomed TUPE as a way of softening the incentive to slash terms and conditions in procurements based heavily on price.

The problems associated with pursuing low-price bids for complex public services have long been understood, and over the years, a succession of NAO reports and government reviews have warned about the consequences. In going back over some of these old reports, it is striking how often it was the industry which objected, pleading with government not to pursue low-ball bidding. Experienced public service providers understand that it will be difficult for them to abstain from bidding if their competitors persist. They also understand the impact that low-price competition will have over time on relations with their government customers, with the public at large, with staff and unions, and ultimately with investors and analysts.

Sir Michael Latham raised this issue in his report on procurement and contract management in public sector construction as far back as 1994 (although the Audit Commission and the National Audit Office has already discussed it in some of their earlier reports):

. . . clients should choose their contractors (and consultants) on a value for money basis, with proper weighting of criteria for skill. Choice of the lowest tender may neglect considerations of cost in use or indeed final (out turn) cost of the project. . .

This concern was echoed by a senior official of a particular local authority: 'Local authorities are severely hampered by being forced to accept the lowest tender. I know that we are not so forced but the overpowering attitude of local authority officers is that for all intents and purposes we are. . .'

The National Audit Office have made it plain that it is not necessary to choose the lowest tender. The best tender should be accepted. . .<sup>15</sup>

Price-based procurement continued to be a major concern for industry over the decade that followed, repeatedly being raised in meetings with government. Peter Gershon mentioned this in his 1999 review of procurement in civil government:

Despite declared Government procurement policy being based on value for money rather than lowest initial cost, many inputs from industry

highlighted a perception that the culture of the Civil Service is risk averse and the 'safe' option is justifying the lowest up front cost. While Invitations to Tender do usually specify the value for money criteria, it does not appear to be standard practice even to specify the relative priority and weightings of the different criteria.<sup>16</sup>

It was raised again in 2003 in a report by the Office of Government Commerce on 'increasing competition and long-term capacity planning in the government marketplace':

As far as price is concerned, there is still a widespread supplier perception that many public sector procurers continue to over-emphasise lowest cost at the expense of other factors. Departments sometimes claim that they cannot afford to do anything else. If true, the implication is either that those willing the ends are not providing the means or that the departments concerned are trying to do too much.

Lowest price does not, of course, necessarily mean best value for money. The public sector may be buying wrong or inadequate things. Low initial prices may be followed by substantial bills for post-contract variations. . .<sup>17</sup>

There have been times when greater emphasis has been placed on value than on price, but almost a decade and a half after the OGC's report, the problem of low-price bidding has returned. Indeed, based on the remarks of survey participants, it would seem that the problem is worse now than ever, reinforced by the government's sustained focus on austerity.

While the Crown Commercial Service has recently acknowledged the need for a 'balanced scorecard' in capital works procurement, with a focus on value for money rather than just price, in practice, the past few years have been dominated by low-price bidding.<sup>18</sup>

Several survey participants gave examples of tenders where price and quality were meant to be balanced but where, because of the structure of the assessment process, tenders wound up being assessed solely on price. It was not unusual, they said, for potential customers to speak about quality and innovation in the early stages of the procurement, but then to focus almost exclusively on price.

Examples were cited where suppliers had signed contracts that reduced prices by 25-30% for services that had already been market-tested several times. The NAO provides a number of studies which corroborate these accounts.

As the Home Office was being subjected to ongoing spending cuts, it chose to make significant savings from its contracts. When Yarl's Wood Immigration Removal Centre was re-tendered in 2014, the successful proponent promised a cost reduction of around 25%. Savings were to be made, in part, by having detainees undertake more activities on their own behalf, a proposal that seemed to have merit. However, the NAO has since reported that the assumptions were unrealistic, and the facility wound up with insufficient staff.<sup>19</sup>

With the procurement for the management of primary care support services undertaken by NHS England in 2015, the annual cost of the service was said to have been reduced by 30%.<sup>20</sup> Government sought to acquit itself of responsibility for the initial poor performance of this contract, seeking to lay the blame entirely on the contractor.<sup>21</sup>

This is madness – in the absence of some major technological breakthrough, no provider can hope to deliver real productivity savings of this scale over the short-term, particularly with a service that has already delivered significant cost savings. Some successful bidders have lost money on such contracts and/or they have run into performance problems. In some cases, they have been forced to surrender their contracts early due to financial stress and/or reputational harm.

There are harsh realities here that cannot be wished away. It is rarely possible to cut costs by one-third on services that have previously been market-tested, or to fundamentally reconfigure the delivery of complex services at short notice – and this applies whether services are delivered by the public or the private sectors. If you attempt to do so, you end up with frigates without missiles, aircraft carriers without aircraft and prisons that are so understaffed that assaults and suicide rates soar.

#### 2.1.1 Why do companies continue to play?

There are a number of reasons why senior executives sometimes act against the medium- to long-term interests of themselves and the company's owners and investors in bidding for the right to manage public services.

*Bounded rationality* – At one level, this is simply a problem of 'bounded rationality' – company executives are human beings, subject to the limitations of the human condition, and they are often obliged to make decisions with little time, drawing upon limited information.

But there are also cultural and systemic explanations for this behaviour.

*The winner's curse* – These are procurements where the winner always loses money and/or reputation by bidding too low (or too high, depending on the nature of the tender). While the concept has since been adopted by economists, the 'winner's curse' was identified by a group of engineers in the oil industry in the early 1970s.<sup>22</sup> It occurs in particular circumstances – where bidders have incomplete information about the good or service for which they are bidding (and thus its true value), and where there is intense competition based heavily on price. Given the complexity of most human services, and the fluid policy environment within which they are delivered, it is almost inevitable that the first of these conditions will exist in competitive tendering for public services. There is only one way of winning a true 'winner's curse' procurement – not bidding.

*Sunk costs* – When the timetable for a procurement repeatedly shifts to the right, it may be rational for providers to spend additional money on the bid at each new stage, so they remain in the race. If the company has been down-selected to a short-list of two or three, this will often be a better use of scarce bidding resources than starting again in an entirely new tender. If providers had been aware of the total costs at the

outset, they might have decided not to bid, but when additional expenditure is demanded incrementally, it may be quite rational to keep spending.

*Lack of understanding* – In some cases, new entrants may put forward unsustainable prices simply because of their lack of familiarity with the service in question. In several central government markets in recent years, the most optimistic bids were submitted by new entrants and companies that had few alternatives. Procurement teams should be extremely cautious in such circumstances.

*First-mover advantage* – Some companies have been prepared to bid low and/or take on unmanageable risks for newly-contracted and little-understood services in an attempt to secure first-mover advantage. The argument is that the low margins or potential losses are an investment in R&D, and that, if it wins, the company will have a competitive edge over later entrants. While this is a rational strategy, it fails when the cost of investment is too high and/or where the market fails to expand as anticipated.

In one large contract (where the successful bidder is now losing money), a senior manager instructed the bid team to reduce their price by 20% because of the supposed opportunities which this contract would open up. I was told that the leader of the bid team was ashen when it was announced that the company had won, because he knew that they did not have a solution at that price. The anticipated market never emerged.

*Last-survivor advantage* – In a market or a procurement that is rapidly thinning due to declining quality, providers might conclude that the survivors will occupy a favoured position with the customer, or that the market will become an oligopoly (so that the remaining suppliers will be able to demand higher prices once again). This is somewhat like a game of chicken, and those that remain are likely to be those with deep pockets and/or those who are prepared to assume the biggest risks.

In one medium-sized procurement, delay resulted in the three short-listed bidders collectively spending almost as much in bidding as the contract was worth. As the tender dragged on, two of the bidders withdrew. An executive from the third company said that as the final bidder, they expected to demand a higher price.

*Relational contracting* – For a time, based on previous experience with customers who were more forgiving, companies have been prepared to undertake complex tasks that were not fully understood, on the assumption that adjustments would be made as the circumstances were clarified. In a highly contractual market, this is not sustainable, and the author was provided with several examples of this behaviour in recent years.

*The prisoners' dilemma*<sup>23</sup> – The chief executive of one large provider said that companies had no real alternative except to bid low given the expectation that their competitors would be doing likewise. They took the view that they could build up profitability later. Legal constraints on collusive tendering make it impossible for competitors to signal their true intentions in the process of bidding.

*Professional bias* – Bid teams are often motivated to 'close the deal', without due consideration of the impact on colleagues who will be responsible for operating the

contract. While financial incentives may exacerbate this problem, professional culture is usually sufficient to encourage bid teams to behave in this way.

People who view the contract as the conclusion and see themselves as solely responsible for getting there behave very differently from those who see the agreement as just the beginning and believe their role is to ensure that the parties involved actually realize the value they are trying to create.<sup>24</sup>

Some companies have managed this much better than others. In one large corporation, for example, there is no distinction between sales and operations – the executives who will be responsible for ongoing management prepare the bids.

*Bid fever* – But even when operational teams are deeply engaged in the procurement, they can become caught up in the excitement of the bid and make poor decisions on price and risk. In one prominent central government contract, where the operational team led the bid, the senior responsible executive admitted that he had become over-enthusiastic about winning.

The term ‘bid fever’ was coined a decade and a half ago by a senior Treasury official in one of the Australian states, who had been responsible for letting a large public transportation contract. One of the successful bidders, a British transport company, eventually walked away after losing well over a hundred million dollars. A senior executive of that company later explained that the bid team was influenced by a short-term focus within the company on growing revenue – but this perverse incentive had been intensified when the procurement team deliberately fed information back and forwards between shortlisted bidders. The Treasury official later acknowledged that in doing this, they had induced bid fever.

*Short-term incentives* – A senior executive from a provider which was about to be sold, acknowledged that as the prospect of sale grew closer, aggressive bids were submitted as a way of boosting the forward order book. It was expected that the purchaser could not quantify the risk of low profitability in the course of the due diligence.

*Reputational incentives* – Where a company has held a high-profile contract for many years, senior executives will not want to lose to their competitors, nor will they want to explain to analysts and investors why they have done so. As one survey participant expressed it: ‘It takes a lot of steel to hand back a contract or to walk away from a contract you’ve already had’.

A senior executive working for a large provider advised the company to hold its nerve when bidding for a set of regional contracts, being tendered nationwide. Both the scale and the scope of services were being significantly expanded, and new entrants were being actively encouraged to enter the market. He had a great deal of experience in the sector, and offered to submit his resignation if the company did not win a significant share of the contracts. In the result, it won only a couple of the contracts, although because the company had bid responsibly, these would subsequently prove to be profitable and perform well. The company accepted the executive’s resignation.

*Expectations of growth* – The remarkable success of the large UK public service providers in recent decades resulted in a several of them joining the FTSE 100 and FTSE 250. Some of these companies found it difficult to manage the expectations of investors and analysts who expected historic growth rates to persist. This placed relentless pressure on senior executives to grow, with companies bidding for large and complex contracts they little understood.

A former senior executive in one large firm said that the pressure for growth meant that the company had to keep moving into new, edgy markets, at a faster rate than could be accommodated. In such contracts, he said, you needed 18 months to understand the service and deliver the promised change, but head office wanted the bid margin immediately.

The chief executive of another major provider said that North American investors in particular had unrealistic expectations about margins and adopted a short-term perspective which were dangerous to the traditional business model of UK public service providers.

The dynamics of bidding in low-price public service markets have not been studied, but it seems likely that companies with less exposure to any single customer, either because of international operations, or because of much greater involvement in the private sector, have been better able to resist the race to the bottom. It follows that the move to centralise government procurement, which has made the market more monopsonistic, has increased the risks to providers.

Where government moves to contract new services, companies which specialise in a narrow range of services (such as facilities management, engineering services and business process outsourcing) may have a better grasp of their limitations, and take fewer risks in an aggressive price-based procurement.

#### 2.1.2 Why does government keep doing this?

It is generally understood that, in a climate of austerity, public officials may feel that they have no alternative to using competition to drive down price. But this was a problem long before the global financial crisis, and the question remains as to why, given the likely consequences, departments and agencies are not more measured in their use of price-based tenders.

In large part, providers see it as a function of risk aversion. Despite repeated clarifications over the years, there is still a widespread belief that civil servants who do not place a heavy emphasis on price will be criticised by the NAO and the PAC. There is concern that relying on criteria that are less easily specified and thus scrutinised might lead to more corruption. As one survey participant expressed it: 'No one ever gets fired for going with the lowest price'.

A senior executive with a large provider, who used to work on procurement in the public sector, suggested that there is a profound difference between the annual budget framework within which public officials usually operate, and the commercial mindset which prevails in the private sector:

The mentality [in government] is that you are managing a budget, rather than managing value. Value is seen as 'jam tomorrow'. Budgetary issues are today.

But ministers and civil servants also assume that the self-interest of providers will act as a natural brake to prevent a race to the bottom: they fail to understand that companies can be induced to act against their own long-term interests. This too has changed over the years. As one experienced executive explained:

It used to be the case that government would call out unsustainable low prices – that has stopped over the last 4-5 years. They are now accepting bids that can't succeed.

One senior civil servant involved in the commercial service told the author that, in his view, if two bidders persisted in offering exceptionally low prices, he felt obliged to accept the lowest, even if he believed that it might be unsustainable. It has not always been so.

That this is a problem right across government is implied by the NAO's report on the DWP contracts for health and disability assessments:

In the Department's view, it considered and challenged potential bidder optimism and did not know bidders' assumptions were unrealistic. It told us optimism in targets was not its responsibility, rejecting provider concerns is a normal outcome in negotiations, and that as providers signed contracts they had accepted the contract terms and risks.<sup>25</sup>

Again, this is not a recent insight: a major report commissioned by the Chancellor and published by the Office of Government Commerce in December 2003, warned:

An essential part of client capability is to ensure that sufficient attention is paid to implementability and to what the supply market can deliver when policy is formulated and targets are set. There is considerable evidence from Gateway reviews that this is not yet sufficiently firmly embedded within departments' psyches. Suppliers can often make this worse by promising more than they can reasonably expect to achieve. Officials do not want to be left looking less ambitious about public sector reform than the private sector. Neither helps effective competition. Moreover, failure to ensure that policy is implementable may appear as an industry capacity problem when in reality it is a problem with the way in which the requirement is formulated.<sup>26</sup>

## 2.2 Aggressive Risk Transfer

Industry is gravely concerned about government's attempts to transfer risks which it is not able to manage – the Crown Commercial Service issued a policy note on this problem in December 2016, although it failed to acknowledge the seriousness of the problem.<sup>27</sup> Risk transfer was mentioned more often than anything else by survey participants as they sought to describe the current state of the market.

Again, in seeking to understand the nature of this practice, it is important to understand that it is not a recent phenomenon. It was raised in April 2004, for example, at meeting of the chief executives of leading ICT providers with the new head of the Office of

Government Commerce, where they complained that there was too much emphasis on avoiding risk and laying blame. Government's insistence on unlimited liability was of particular concern. The divisional head of a large provider said that their lawyers had identified five provisions that they argued about with the government in each new contract. Each new negotiation started afresh, as if the discussions in previous conversations had never taken place.

But again, this problem seems to have become much worse in the past couple of years. Several of the larger providers said that this was a significant reason why they were now qualifying out of more procurements. One chief executive said that they had withdrawn from an entire market sector because of a shift to unlimited liability.

Contrary to the longstanding policy of government, restated in the 'Government Commercial Operating Standards', that 'risks are allocated to the parties best placed to manage risk'<sup>28</sup>, the experience of recent years has been that procurement teams are aggressively seeking to maximise risk transfer:

They say that risk should lie with the organisation best able to bear it, but that does not translate into practice.

As recently as August 2015, the Ministry of Defence introduced a new policy relating to limitations on contractors' liability which was inconsistent with the policy restated by the CCS in December 2016. This document starts with the legal position under the Sale of Goods Act, with the underlying assumption that all of the risk lies with the supplier. While the policy does acknowledge the longstanding principle that risk should be allocated to the party best able to manage it, and recognises that there is scope for accepting liability based on a value-for-money assessment, the overall tone of the document is clear.

Procurement teams are advised that suppliers primarily seek to shift risk in order to protect profitability: 'Contractors seek a Limitation of Contractor's Liability as it is a mechanism for them to pass financial liability for risks they hold to the MOD'.<sup>29</sup> The policy assumes that the limits of contractor liability should be set by the law on damages for breach of contract, and 'the MOD should only offer a Limitation of Contractor's Liability in very limited circumstances.'<sup>30</sup>

A leading defence contractor explained that this document represented a marked departure from the department's longstanding approach to the allocation of risk (inconsistent though it had been in its application), and combined with an onerous approvals process for obtaining a limitation on liability, it had contributed to a much more aggressive attitude to risk transfer amongst less experienced staff.

Since the Crown Commercial Service did not object to this policy when it was released, it was reasonable to conclude that it reflected government policy at the time.

Excessive risk transfer has assumed a variety of different forms:

- *Data risk*: 'They are trying to transfer risk that government itself hasn't bottomed out'. Survey participants gave examples where they had been obliged to rely on data from government that either didn't exist or was of such poor quality that activity levels and workflow used as the basis for pricing did not eventuate.

The chief executive of a major company said that they were increasingly dealing with unknowns: 'They don't know internal costs or volumes, and they throw the risk on these things across the table'. A senior executive of another company spoke of a facilities management contract for an NHS Trust, where there was the potential for significant liabilities because of the poor quality of the estate (including an asbestos problem). The contractor was expected to accept liability for the existing buildings without a detailed survey, which they were not prepared to do. However, one of their competitors was.

The CCS specifically refers to poor quality data in its December 2016 policy note on onerous procurement practices, and recommends that departments and agencies engage with their suppliers on such matters before going to market.

- *State-Aid Risk:* One survey participant said that they had been asked to take on state-aid risk, which could have been more easily mitigated by the customer since they were an agency of government.
- *Policy Risk:* Providers have been asked to assume the risk of legal and policy changes, which are wholly beyond their ability to manage.
- *Coordination Risk:* Examples were given of services which rely on the cooperation of other departments and agencies, or local authorities for improved delivery, where the provider was expected to take on responsibilities for collaboration that government itself was either unwilling or unable to manage.
- *Capital Risk:* In the NHS, companies are being asked to take on the responsibility for significant capital investments with short contract durations of 2-5 years. Customers are insensitive to the risks this creates, and contractors have been told that they are their responsibility.
- *Unlimited Liability:* Companies are frequently expected to accept unlimited liability – the commercial director of one large provider said that 'the standard contract these days has unlimited liability'. He gave the example of a contract worth only £300,000, where the customer was insisting on unlimited liability, a parent company guarantee, all consequential costs and no variations. The global head of a service sector for one large corporation (and a former public servant) insisted that there had to be a number if risk was to be priced, even if it was a high one.

Another example was that of a contract where the company was competing with an in-house team. Bidders were required to accept unlimited liability, which the company refused to do. Their bid was treated as non-compliant and was

not even considered, with the result that the contract was awarded to the public-sector provider and thus the state was not relieved of any liability.

Among other things, the pursuit of unlimited liability (and parent company guarantees) has been criticised for the impact which it has on SMEs, but the problem persists.<sup>31</sup> A number of survey participants acknowledged that the position has improved somewhat through the intervention of the commercial directors operating under the government's Chief Commercial Officer.

- *Excessive Performance Bonds*: the example was given of a £500,000 performance bond on a £1m contract. The CCS has now specifically recommended that deeds of guarantee and performance bonds only be employed in specific circumstances 'where the contract is judged to be at high risk of supplier or performance failure'.
- *Others*: Providers have also been asked to accept responsibility for break clauses without costs, all consequential losses and uninsured relief events. In the latter example, the customer could not identify what this might involve but insisted nonetheless.

There have been vigorous exchanges over these matters – 'the commercial guys negotiated on it until they were blue in the face'; 'the attempt to maximise risk transfer continues – conversations are going nowhere' – but for the past few years, experienced providers were prepared to accept risks that they were not able to manage.

#### 2.2.1 Why do companies continue to play?

Survey participants found it difficult to explain why they had accepted risks they were unable to manage. This is possibly because the costs of poor decisions in this area are more difficult to quantify, making it harder to control optimism bias and bid fever. One chief executive suggested that new market entrants may be particularly vulnerable – they have a less detailed understanding of the risks and are unable to price them correctly: 'and then they fail, and government gets disappointed all over again'.

It is possibly because many of these risks are assumed in the one-on-one negotiations that take place at the end of the procurement process. In this area, perhaps more than any other, the shift from a relational to a transactional form of contracting seems to have had a significant effect. Several company executives, one of whom had served as a senior ministerial adviser, said that contractors seem to have taken the view that they would accept the risk and find a way around it later on. In a highly commercial environment, this would be regarded as gaming – but where the intended outcomes and the nature of the services in question are not fully understood, and where the process of contracting provides a vehicle for clarifying the same, then a flexible contract with scope for the adjusting the risk profile makes a great deal of sense.

### 2.2.2 Why does government keep doing this?

While the policy note issued by the CCS seems to acknowledge that aggressive risk transfer has become a more serious problem in recent years, it is evident that this has long been an issue in government procurement.

Among survey participants, the most frequent explanation for this behaviour was the public sector's aversion to risk. A senior executive of an international provider which does a great deal of work in the private sector, contrasted the behaviour of public officials.

With the private sector, it is: 'How can I better serve my customer?' There are benefits for innovating and risk-taking in doing that. The public sector is more insular, more self-focused. There is a lot of self-justification.

He saw risk management as the core business of the Civil Service – although it is political and reputational rather than commercial risk. The term 'blame culture' was used by many of the survey participants to describe attitudes in the public sector.

More than with low-price bidding, risk transfer seems to be linked to a perceived disregard for the private sector and a belief that because companies are making a profit, they can be expected to carry inordinate amounts of risk. As company executives saw it, the attitude was:

We're going to get these b.....ds since they are going to make money out of this.

Here's the risk – you think you're so smart, you can cop it.

You're making a profit out of this, so you can carry all the risk – or we will find someone else who will take it.

Again, suppliers link this behaviour to a belief within government that there is an endless supply of firms waiting to break into the market. One commercial director with a background in government said that the attitude was: 'If it's so bad, why do you keep bidding? More people will replace you.'

They see a distinction between the attitudes of senior and more experienced commercial specialists, and the more junior officials usually involved in procurement teams: 'Senior commercial people say it is a starting point but junior people don't see it that way'.

Providers report they are now being more careful in the risks they accept, but they are still concerned that competitors, particularly new entrants, have not learned the lessons.

### 2.3 Market Models

One of the most important insights from this project is the need to recognise that the procurement and contract management tools that are appropriate for buying 'paperclips' – highly commoditised, easily specified goods and services – are not appropriate for commissioning complex support services and front-line human services.

Contract form must follow service function – and if government is not willing to adapt its contracting models so that they are appropriate to the services being put to market, then the range of functions included in the contract will inevitably shrink. Highly transactional contracting forms are appropriate for simple functions but not for complex services.

### 2.3.1 Relational to Transactional

Relational contracting has been defined as an arrangement which places greater emphasis on the ongoing commercial relationship between the parties. There is greater reliance on informal agreements, and trust is generated and maintained through personal relationships, reputational incentives and the expectation of future business dealings rather than financial penalties and legal sanctions.

Some private markets rely heavily on relational contracting; indeed, academic awareness of this approach to contracting dates to a study of the manufacturing sector in Wisconsin undertaken in the early 1960s, which observed, among other things:

Businessmen often prefer to rely on ‘a man’s word’ in a brief letter, a handshake, or ‘common honesty and decency’ – even when the transaction involves exposure to serious risks. . .

While a significant amount of creating business exchanges is done on a fairly noncontractual basis, the creation of exchanges usually is far more contractual than the adjustment of such relationships and the settlement of disputes.<sup>32</sup>

In the UK public sector, this approach to contracting was reflected in a focus for some years on partnering, although terms such as ‘collaborative contracting’ and ‘high-trust contracting’ have also been used. A literature had begun to emerge about the use of relational contracting in the UK public service economy throughout the 1990s and 2000s.<sup>33</sup>

Public service contracting has since become much more transactional – although lip service is sometimes still given to more relational models of the past. One experienced bid director said that he was tired of hearing talk of partnership and then encountering aggressive contracting behaviour. A chief executive with a distinguished career in the public sector reported that: ‘Government is full of promises – equal terms, partnership, proportionate risk – but when you get down to it, the relationship is unilateral’.

Providers also report that some departments and agencies do acknowledge the complexity of the services they are putting to tender, and engage in intelligent dialogue with potential suppliers with the objective of developing mature relationships. But there are certainly a number of major departments where contractual dealings have become highly transactional.

Survey participants reported a move towards smaller contracts of shorter duration, an increased focus on low price and risk transfer, a more adversarial approach to contract management, with the emergence of a ‘policing mentality’ and a greater reliance on financial penalties. (Of course, exceptions were also mentioned.)

This has been associated with a more ‘commercial’ approach to contracting – a renewed emphasis on contract management which focuses heavily on monitoring and

enforcement. (Private firms that rely on relational contracting would no doubt dispute the proposition that they were behaving in a less commercial way than government, so the recent use of the term assumes a particular approach to commerciality.) Cabinet Office documents and NAO reports now focus more on 'commercial' capabilities and less on partnership skills.

None of the providers interviewed in researching this paper disagreed that government needed to become more effective in its dealings with contractors. They accept that some of the practices that had emerged in the market were politically and commercially unsustainable.

To acknowledge this, however, is not to endorse the aggressive and highly transactional form of contracting that has been adopted by many departments and agencies. It was entirely possible for government to have addressed its deficiencies in procurement and contract management without abandoning the use of relational contracts and the principles of partnering for complex services (although whether it could have done so in a climate of extreme financial stress is not so clear).

It appears that there is scope for a one-off financial gain when the dominant party suddenly shifts from a relational form of contracting to an aggressively contractual one. Arguably, this is what happened in the UK market over the past five or six years. Government has exploited its supply chain, extracting large cash payments based on the expectation of additional contracts, adopting an adversarial approach to the interpretation of contract clauses and in the process extracting significant financial abatements or penalties in circumstances where, traditionally, a more collaborative approach would have been adopted. (Again, there are exceptions.) Such a sudden shift in the terms of exchange has reaped huge financial dividends, at the expense of social capital and trust.

### 2.3.2 Commoditisation

When new public service markets are first emerging, particularly those for services which have no private sector equivalent, suppliers are on a steep learning curve – they are obliged to innovate in order to deliver better value-for-money. There is no common understanding about how to improve these services and each contract is, in many ways, unique.

Some of the early entrants in the UK public service economy developed a business model that was based on a deep understanding of the customer and being responsive to their particular needs. Rather than having a standard product which was sold repeatedly to different customers, providers prided themselves on being 'customer-facing' and delivering bespoke services that addressed the separate requirements of each individual department or agency.

In this respect, they were similar to consulting houses. Professor Clayton M. Christiansen has described these kinds of firms as 'solution shops' – 'structured to diagnose and solve unstructured problems'.

Solution shops deliver value primarily through the people they employ – experts who draw upon their intuition and analytical and problem-solving skills to diagnose the cause of complicated problems. After diagnosis, these experts

recommend solutions. Because diagnosing the cause of complex problems and devising workable solutions has such high subsequent leverage, customers typically pay very high prices for the services of professionals in solution shops.<sup>34</sup>

Christiansen contrasts 'solution shops' with 'value-adding process businesses', such as automobile manufacturing and petroleum refining, where firms 'take in incomplete or broken things and then transform them into more complete outputs of higher value'.

Over time, as the goods or services in question are better understood, these value-adding processes are separated from the solution shop, causing costs to fall dramatically. Christiansen has closely studied the health sector, where certain medical procedures (such as eye surgery and heart surgery), once delivered by highly-paid specialists under a 'solution shop' model, are being routinized, with the result that high-quality procedures can be delivered today at a much lower cost.<sup>35</sup>

Unlike consulting firms, which are only responsible for analysis and design, public service companies underwrite their proposed solutions by accepting the responsibility for delivery, and their business model enables them to adjust their solution over time. They have always stood partway between 'solution shops' and 'value-adding process businesses', and for them, the process of standardisation, commoditisation and systemisation has involved a change of emphasis rather than an abrupt transition to a radically different model.

It is inevitable that markets will become commoditised over time, with systems and processes becoming standardised, routinised and imitated by competitors. As this happens, risks are better understood and better managed, prices fall, new suppliers enter the market and companies are obliged to accept narrower profit margins.

Providers would like to be paid 'solution shop' prices for services that are essentially process-based. 'Step and repeat', a term now widely used among the private providers of UK public services, points to a process of commoditisation, and company executives see this as a way of reducing prices and, for a time at least, growing profit margins. This transition may have been accelerated by the entry of firms and senior executives familiar with more commoditised markets.

The chief executive of a medium-sized provider thought that commoditisation has largely been driven by industry: 'There has been a race to commoditise services over the past five years. Contracts are bigger and companies believe they can offer lower prices through economies of scale'.

For government, the standardisation of services and the commoditisation of markets means that they can conduct price-based procurements with less risk of inducing a winner's curse. The Government Purchasing Service was established in 2011 as an agency of the Cabinet Office, with the self-declared mission of demonstrating 'that significant and substantial savings can be achieved through centralisation, aggregation and standardisation'.<sup>36</sup>

The growing use of e-auctions and the preference for off-the-shelf solutions in the procurement of public services provide clear evidence of the shift that occurred around

that time in UK government. Indeed, government has deliberately recruited executives from the private sector whose experience lay in tenders and auctions for highly commoditised products.

The danger is that if government treats complex public services as commodities when they are not capable of being standardised, this will encourage a focus on price and an unintended decline in service standards. There are examples of e-auctions being used for complex public services, with providers being caught up in bid fever as a result. One experienced bid director, who has worked for three different public service companies over the years, said that they had recently no-bid a major contract precisely because it was being tendered through an e-auction. He had asked his team why they thought that tendering a complex public service through an e-auction was likely to end happily.

A senior civil servant with a long background in commissioning offered the view that very few government services are commoditised. This is certainly true of front-line services – the complex nature of ‘public purpose’, the untidy interface with policy and politics, and the vulnerability of many of government’s clients ensures that this is so.

Standardisation also has the effect of suppressing service innovation, so before moving down this path, departments and agencies must feel confident that the services in question have little to gain from further experimentation (beyond process-based innovation).

### 2.3.3 A Conflict of Interest

Government has two roles when it comes to the design and operation of public service markets: it is both a player in the market and the regulator, with the responsibility for ensuring that the various participants play by the rules. There is potential for a conflict of interest between these two responsibilities, and if it is not recognised, government-as-customer may change the rules to the disadvantage of its suppliers, who will be unprotected by government-as-regulator.

There is an historical case study which demonstrates what can happen when these two roles are confused. Most public utilities – electricity, water and gas – and public transportation systems – heavy and light rail – were originally conceived and developed, financed, constructed and operated by private firms. For the most part, these were natural monopolies, so that franchises were let, and price and quality were regulated, by municipal authorities. There was a significant degree of lock-in under this model – municipal authorities and utility companies made irrevocable investments in these facilities, as did customers, and it was rarely feasible for other suppliers to duplicate them.

In time, for reasons of social policy and self-interest, local politicians began to behave opportunistically, suppressing prices ‘in the public interest’, and insisting that services be extended to remote corners of the municipality where the returns did not cover the investment. They exploited their powers as regulators to benefit themselves as the customers’ agents, at the expense of providers who had made irrevocable investments.

Ultimately, this was commercially unsustainable, and there were two alternative models which resolved the impasse. The first was municipalisation – local authorities acquired the utilities and owned and operated them as public enterprises. Investors were often willing to sell their shares because it enabled them to recoup at least some of their investment.

The other stable solution lay in the take-over of the regulatory and price-setting functions by national or provincial governments. By removing price regulation out of the hands of the consumers' agents (municipal politicians), private utilities and their investors were reassured that long-term considerations such as return on investment would be taken into account.<sup>37</sup>

Contracts under the Private Finance Initiative (PFI) bear some similarities to utility franchises, particularly because of the sunk costs associated with infrastructure investments. But in some circumstances, private providers of public services may also find themselves locked into a market with high exit costs. Under these conditions, they will have few options, in the short-term at least, if the customer abuses its monopsony power and interprets the rules to its own advantage. Over the medium- to long-term, this will destroy trust in the integrity of the system and result in companies withdrawing from (or not entering) the market.

#### 2.3.4 Loss of Trust

Trust is a form of social capital – in commercial relations, it provides 'order for free' (or at least at a substantial discount). When trust is lost, customers and suppliers must invest more in systems and processes that can serve as substitutes: survey respondents reported that negotiations are now more often dominated by lawyers and compliance experts, rather than people concerned with operations.

They use an army of contract monitors, so you bring your own.

One participant reported that his company was now sometimes appointing lawyers as contract directors. It does not require a deep understanding of the delivery challenges faced by the human service providers to know that this is not a desirable outcome.

Government's loss of faith in the private sector was undoubtedly influenced by the global financial crisis in 2008. Within a year or two, the government began to adopt a more aggressive approach to managing its supply chain, and in 2013, government's trust in its suppliers was shaken by a controversy involving two large providers in the justice sector.

In part, this has involved a loss of trust in the *integrity* of private sector providers. It is not yet clear whether there was any criminality involved in the highly-controversial electronic tagging contracts, but government certainly felt that these companies had exploited the relationship. There is still a view at senior levels in some government departments that suppliers are routinely gaming the system.<sup>38</sup>

But there has also been a loss of trust in the *capability* of providers. One senior civil servant (identified in the interviews) was reported as saying to the representative of a major provider: 'You never do what you say you're going to do'. Established providers

are seen as having accepted responsibility for services which (at the negotiated price and timetable) they are not able to manage.

In a recent article, the *Financial Times* suggested that this problem might have been exacerbated by the rapid growth of the industry, with some companies not able to develop bidding and management capability at the rate at which they were winning contracts.<sup>39</sup>

And in some quarters, there may be a *loss of confidence in the institution* of contracting itself. To some extent, this uncertainty arises from repeated reports of failure on the part of government, but this in turn has raised questions about the limits of control under a contractual model. In a meeting with industry, another senior civil servant expressed his view that contracting was suitable for procuring paperclips, but not for complex public services.

At the same time, however, providers have been losing faith in government. This can be traced to the decision in 2010 to extract large cash payments – hundreds of millions of pounds – from its major providers with no legal or contractual foundation. The content of these conversations has never been disclosed, but the chief executives who were called to these meetings certainly understood that their standing with government would be affected by their willingness to cooperate. In the opinion of some providers, the relative ease with which ministers were able to extract these payments led them to believe that the industry could be squeezed a great deal harder. It matters not whether this is an accurate representation of what ministers were thinking at the time – it is what senior executives in the industry independently concluded the situation to be.

Such practices are sometimes used in the private sector, but they are regarded as a particularly aggressive way of managing a supply chain, and courts and competition regulators have taken the view that they are an abuse of bargaining power and ‘conduct not done in good conscience’.<sup>40</sup>

While government codes of conduct insist that public sector employees should treat suppliers with fairness and respect, the conduct of ministers and civil servants in 2010 can reasonably be described as unconscionable – and suppliers had no effective recourse. There is no question that this behaviour shook the industry and compromised the trust relationship that had been built up over some years.

There is a belief in the industry that government has sometimes abused its position as a monopsonist, that competitions involving government-owned enterprises and social enterprises underwritten by government, have not ensured a level playing-field, that (in public at least) departments and agencies have not been prepared to acknowledge their own failings in some of the contracts that have run into difficulty.

Contractors regard some commonplace procurement practices, such as delaying or deferring bids in the interest of achieving better outcomes, as a fundamental breach of trust and thus unethical. It usually comes as a surprise to public officials to learn that contractors regard these practices as unethical. They are not dealt with in the Civil Service Code or in codes of conduct relating to procurement and contracting.

In part, this is because the two sectors view trustworthy and honourable conduct in different ways. This was suggested by a survey of government contractors conducted by the NSW Independent Commission Against Corruption (based in Sydney, Australia) some years ago, which found that some private suppliers thought that public sector ethical standards were lower than those in the private sector. Their reasons for taking this view included 'the inability of employees to take ownership or responsibility for the contracting process, lack of performance orientation and lack of accountability regarding time management'.<sup>41</sup>

These issues go to the perceived *integrity* of government as a commissioner and manager of contracts, and they have a profound impact on the capacity of the UK public service market to sustain contracts for complex services.

A commercial director of a large company reported that they were losing significant sums of money on a major contract, but no one in government believed this, or it was excused on the basis that the company must be making money on other contracts. The attitude was: 'Accountants can fiddle the figures'.

On another highly-successful contract, with open book accounting, the customer refused to accept that the company was making a loss. Despite having been shown the numbers, the response of the contract director was, in effect (as the provider saw it), that the company must be lying. Only recently has the customer been prepared to engage with the supplier in the pursuit of cost reductions, because the contract is coming up for rebid. There is a real prospect that the company, a long-term supplier of this service, will not tender, and there are now concerns that the service will cost significantly more following market-test.

In a PFI contract with a gain-sharing clause, the customer employed a consulting firm to trawl through old accounts, using indexation analysis to insist that profits had been excessive throughout the seven years of the contract, and must be repaid.

The suggestion was that it was 'morally corrupt' and there was all kinds of pressure to give it up. They would stare blankly at you when you tried to explain.

Another manifestation of this loss of trust is a willingness to intervene in detailed management decisions about delivery:

If standards slip, as they sometimes do in the real world, someone comes and counts heads. They argue that you can't be delivering to the contractual standard because they can't see the cleaners on the floor.

Of course, there are goods and services where trust is based on the customer's familiarity with production processes that are highly standardised – millions of commuters negotiate the public transportation systems of major cities on a daily basis without worrying about the contractual niceties. In these cases, the trust is institutional rather than individual. But it is far from clear that this is possible or desirable with complex and non-standardised services, or where services are being delivered to vulnerable individuals.

## 2.4 Systemic Self-Deception

There is a significant amount of evidence, accumulated over many years, that government departments and agencies struggle to maintain a sense of proportion when it comes to major procurements – from a 2001 report by the OECD on IT failures which advised governments to ‘build dolphins not whales’, to the House of Commons Defence Committee’s report in 2013 which recommended ‘fast, inexpensive, simple and tiny’.<sup>42</sup>

But this particular pathology is much older than that. In a paper written in the 1830s, Samuel Bentham – who had been an in-house management consultant to the Admiralty (and was the younger brother of Jeremy Bentham) – commented on the inclination of governments to undertake innovation on a grand scale. This was not, he observed, how the private sector usually experimented: ‘Government have made all their experiments on a *large* scale, while the private man has been content to make his first essays in a petty way’.<sup>43</sup>

To some extent, this is the problem of optimism bias, now well-recognised (although not always overcome) in the planning and execution of major projects. But there is more to it than that – it seems that the adversarial nature of the procurement process and the creation of a strong organisational boundary between commissioner and provider also contributes.

### 2.4.1 Unrealistic Timescales

Take, for example, the tendency of politicians and public officials to set unrealistic timescales for large procurements. This was raised by Sir Michael Latham in his 1994 report on government construction contracting, who warned: ‘A hasty project is unlikely to proceed smoothly. Everyone will lose, and the client most of all’. And by Sir Peter Levene in his 1995 ‘efficiency scrutiny’ of construction procurement.<sup>44</sup>

It was identified as a significant cause of the early problems at Yarl’s Wood Removal Centre, particularly the riots and the fire that damaged that facility in 2002, shortly after it opened. A comprehensive and extremely frank review found that the origins of this disaster lay in a politically-driven timescale. These targets were widely regarded as unachievable, but staff did not believe that they had permission to challenge them. The Prisons and Probation Ombudsman concluded: ‘In future, all targets must be rigorously tested in terms of achievability before they gain currency’.<sup>45</sup>

It seems that no one was listening. The NAO has repeatedly pointed to this as a major source of contract failure in a series of reports from 2002 (at least) to the present.<sup>46</sup> An unrealistic timescale (combined with an obsession about delivering those timescales) is considered to be one of the principal reasons why the NHS National Programme for IT, commissioned in 2002 but still being implemented in the present day, has run into so many difficulties.<sup>47</sup>

The problem is not confined to the UK. The Australian National Audit Office recently reported on the contract with a large private company to manage the government’s offshore immigration detention centres, where politically-driven timeframes meant that the Commonwealth Procurement Rules could not be followed. There was no time for value-for-money assessments when selecting the providers. ‘Services and price were

not agreed between the parties until contract negotiations ended', and in one case, this did not occur until almost five months after operations commenced.<sup>48</sup>

It is not that government has been unaware of this particular form of optimism bias, but that it seems to have had no way of learning the lessons. The National Audit Office has produced excellent reports over many years which have studied the lessons, good and bad, from commissioning, procurement and contract management, and there have been periodic reports by government inquiries and think tanks which have recommended fundamental changes to the way in which government undertakes these activities. Few of these have had a significant or lasting impact.

#### 2.4.2 Failure to Understand the Task

It is also difficult to comprehend how, after all these years, government agencies and private providers can sign a legally-binding contract when they have not reached agreement on the task which the provider will be required to perform. This is such a fundamental failing that its recurrence should cause government to undertake a comprehensive overhaul of all its procurement arrangements.

In its 2015 and 2016 reviews of health and disability assessments, the NAO reported that there had been insufficient challenge of targets and assumptions before the contract was signed. It was recommended in the first report that 'the Department model and test assumptions and encourage challenge from providers', and while there was some improvement over the subsequent year, the NAO found that:

. . . in more recent contracts the Department has continued to develop targets and assumptions without sufficient evidence. Getting such assumptions right is crucial for bidders to determine whether the Department's requirements are deliverable and at what price.

Examples of such behaviour included: setting high volume targets without fully considering feasibility; rejecting provider concerns; failing to share evidence about operational assumptions; and failing to inform providers about wider policies affecting the contract.<sup>49</sup>

In letting the recent contract for healthcare services at Yarl's Wood Immigration Removal Centre, the NHS declined to use a recent health needs assessment as the basis for the service specifications, due to time pressures. The NAO commented: 'It published the invitation to tender with the intention to review the service specification following contract award.'<sup>50</sup>

With a contract for core military flying training, the NAO found:

. . . when the Department contracted for an external provider it had no robust baseline for actual training time and cost, or aircrew ability at each stage of training from selection to combat ready. This lack of robust data limits the ability of the Department to understand performance or set Ascent meaningful performance targets.<sup>51</sup>

With e-borders, the Home Office and the contractor failed to grasp the scale and the complexity of the task. To a significant extent, this related to the number of stakeholders that would be involved in developing a solution:

. . . it does not appear that they [departmental officials] had fully appreciated the multiple challenges and risks inherent in such a broad programme spanning different travel industries and with so many diverse carriers and government bodies with varied systems.<sup>52</sup>

There were legal constraints on the collection of data, which the Department failed to properly evaluate. So, when the contract was signed in late 2007, 'the business case still included no specific acknowledgement of these legal constraints'. Specialist external advice was first commissioned on this question in 2010, as the contract was being terminated.<sup>53</sup>

When a UKTI contract for specialist services was signed in 2014, they had still not finalised key elements of the contract, such as the volume of work, the staff mix, specialist day rates and fixed price elements.<sup>54</sup> Nick Timmins observed similar behaviour in the contracts for the delivery of Universal Credit.<sup>55</sup>

These examples have been drawn from reports published over the past 18 months, and there are many more. This goes to the very heart of the contracting system. Customers and suppliers are signing contracts worth hundreds of millions of pounds without having agreed on the nature of the task and the associated risks. It would be risky behaviour even under a system of relational contracting; given the aggressively commercial environment which has developed in the UK over the past five or six years, it is reckless in the extreme.

#### 2.4.3 The Contractual Boundary

When it is done well, contracting obliges commissioners and delivery agents to clarify the intended outcomes of the service in question, and the resources (people, money and time) that will be required to deliver those results.<sup>56</sup> This was particularly the case with facilities and services procured under the Private Finance Initiative, where the scale of the projects, the extent of risk transfer, and the early involvement of external financiers, resulted in a robust debate over such matters.

This was a deliberate design feature of early PFI contracting. When this model was being developed by HMT in the mid-1990s, Steve Robson, then Second Permanent Secretary of the Treasury, explained that some of their interest in this model lay in the expectation that it would stop the game where agencies lied about costs and benefits until ministers had announced the project.<sup>57</sup> This is now politely referred to as 'optimism bias', but Robson was right in regarding it as a form of systemic self-deception – there appear to be particular circumstances where ministers and civil servants lose their grip on reality. This is not a question of capability but of perverse incentives and cultural settings which robust process arrangements such as gateway reviews can manage only in part.

Done well, contracting serves to challenge this tendency to self-deception. This is the core principle on which the discipline of commissioning is built – commissioners are not only given a range of levers to ensure that the hand-off from policy (and funding) to delivery is managed well, they are also provided with a place to stand. It is as much a question of authority as it is of capability.

When commissioning and procurement are done badly – in circumstances where there is only weak authority or incentive to challenge – the contractual boundary serves to magnify the self-deception (on both sides). And of course, in a market where there is little trust and where both sides are gaming the system, the boundary becomes a conflict zone.

This is not primarily about the public-private divide, but rather an extreme version of the traditional differences between policy and delivery, evidenced by the following example.

In July 2016, the NAO reported on the UnitingCare Partnership, a limited liability partnership formed by two NHS foundation trusts, which won a five-year contract to deliver community services for adults and older people in Cambridgeshire and Peterborough. The contract was terminated after eight months when the parties failed to agree on costs. There appears to have been inadequate attention given to the time and cost of transition, and an optimistic estimate of savings – UnitingCare significantly outbid its private sector competitors in this regard, who were more experienced.<sup>58</sup>

When contracting works, it is because certain design characteristics are in place. The experience of the past few years suggests that when those features are not present – when the self-deception is not challenged – contracting may deliver worse results than when services are delivered directly by public providers and they are funded primarily for capability and flexibility.

## 2.5 Continuity, Capability, Authority

Industry is also highly critical of the way in which government utilises its human resources in the conduct of procurements and the ongoing management of performance. While there have been promising initiatives of late, government has failed to address these issues over many years, and industry remains to be convinced. People are so fundamental to the success of procurement and delivery under contract that these issues are deserving of particular attention.

### 2.5.1 Continuity

Survey participants are frustrated at the high rate of churn among civil servants – they no longer expect that there will be continuity on major procurements or throughout the life of a contract. This is yet another issue of long standing. It was identified by the NAO at least as early as 2004, when it advised against moving contract staff unnecessarily.<sup>59</sup> But it was also being raised by industry. A paper by the Confederation of British Industry, submitted to the Prime Minister's Office in April 2006 following a meeting between the PM and industry leaders, included the following:

There is some concern at the rapid turnover of procurement and contract management personnel within government, and the apparent lack of weighting given to public officials with these skills. We believe that government should find ways of stabilising the engagement of senior personnel involved in major procurements, and in the management of major contracts.

It has been mentioned at regular intervals ever since. In his report on the Universal Credit scheme, Nick Timmins wrote that being the senior responsible owner for this

project proved to be 'only too like being one of Henry VIII's wives: divorced, beheaded, died; divorced, beheaded, survived'.

Over little more than five years, two retired through ill-health. Two were interims, although one of those was key to the attempt to rescue it. One died in harness. One survives. Over little more than five years, Universal Credit has had six senior responsible owners. At one point it had five within a year. And at a level just below that, it has had six programme directors.<sup>60</sup>

The NAO has continued to document similar high levels of churn on other major government contracts, most recently in its 2016 report on e-borders, where the problem did not improve when the service was taken back in-house.<sup>61</sup>

One of the consequences of such high rates of turnover is a lack of experience and competence. It is not unusual, the author was told, for external advisers to be the custodians of corporate memory. In complex public service systems, where there is an ongoing history of deep engagement between customer and suppliers, corporate memory matters. The example was given of a government department with a diverse supply chain, where the two most senior civil servants responsible for system design and management moved on within six months of each other. Given that staff turnover is a significant issue within government, one survey participant suggested that continuity is one of the benefits that private providers might bring to public service delivery.

A second implication is that there is less accountability for results – one participant referred to it as a game of 'pass the parcel' – the medium-term consequences of a decision (or non-decision) are someone else's problem. Another – a former civil servant, who has worked in the Cabinet Office and in Treasury – asked the author whether he could name any senior public officials who had suffered in any way because of a failed procurement. Between us, we could only think of one, and he secured a remunerative job in the private sector. It is likely there are others, but with a long background in the public service contracting, we could not think of any.

### 2.5.2 Capability

A number of attempts have been made over the past two decades to develop what might broadly be called the commercial capabilities of government, with notable success in the disciplines of finance, project management and information technology. However, a great deal remains to be done.

It is difficult to disagree with a recent report by the Institute for Government on government's commercial capability which concludes:

Since the refresh of government's commercial reforms post-2015, progress has already been made by departments and the Cabinet Office, in particular in relation to the recruitment of new staff and the setting up of a new assessment centre. It is still too early to say how far this progress will translate into improved performance.<sup>62</sup>

Use of the generic term, 'commercial capability', masks the existence of a number of different disciplines involved in public service contracting – commissioning, system

design and stewardship, procurement and contract management – and the intense focus on the commercial aspects of these functions has contributed to the neglect of the relational dimensions.

### *Procurement*

For a long time, the capability gap was primarily seen as lying in procurement, reflecting a belief across government that this particular skill lay at the heart of delivery through contract. The scale of the challenge was described by Peter Gershon in his report on civil procurement in central government, published in 1999:

Although there are some very talented and capable people within the Government Procurement Service that is now being established, I concluded that the overall levels of skill, capability and seniority need to be raised significantly. . .<sup>63</sup>

In 2004, the Public Accounts Committee reported that less than a quarter of designated procurement staff had Chartered Institute of Purchasing and Supply (CIPS) or other procurement qualifications, although a further 11% were in training.<sup>64</sup> The improvement over subsequent years was minimal. Little has been achieved since: the NAO reported in February 2013 that only around one-third of staff in procurement departments across government were fully CIPS-trained.<sup>65</sup>

Other than formal training for procurement officers, a number of strategies have been suggested over the years – strengthening departmental leadership on procurement by training senior civil servants; lateral recruitment of people from the private sector with commercial and programme management skills, identifying career paths across the public sector for people with these skills and giving greater weight to delivery skills in the way in which jobs are evaluated.<sup>66</sup>

*Leadership:* In its recent report on commercial capability, the Institute for Government has pointed out that it takes time to build professional capability and commitment to the development of these skills must be sustained.<sup>67</sup> A brief scan of recent history is not encouraging in this regard.

Sir Ian Byatt identified this as an issue in local government procurement as long ago as 2001.<sup>68</sup> OGC raised it again two years later.<sup>69</sup> In 2007, Treasury *directed* that departments and agencies were to ‘give a clear direction from the top about the importance they attach to procurement in delivering departmental objectives’, and ‘ensure that procurement professionals are brought in at the earliest stages of projects, where their skills and knowledge are likely to have most impact. . .’<sup>70</sup>

OGC developed a training module on ‘commercial awareness’ for senior civil servants, although it is unclear that this had a significant impact on the weight given to procurement and contract management at the senior levels of departments and agencies. A cross-government review of 28 major contracts, undertaken in 2013, reported:

The reviews found evidence of a lack of senior level involvement on 9/28 contracts reviewed. There are contracts that have no strategic oversight within

the Department and there is a general lack of visibility of contract performance at Departmental board or executive level.<sup>71</sup>

The campaign to appoint commercial directors to departmental boards and the senior executive was, in part, an attempt to raise the profile of procurement in decision-making. The NAO reported in 2004, that of the twenty departments which spent the most on procurement in 2002-03, only three had commercial directors, whose role explicitly covered engagement with the private sector and procurement strategy.<sup>72</sup>

In this regard, the situation has clearly improved in the intervening years, although given the current state of the market for complex public services, it is to be questioned whether the engagement of senior leadership had changed enough. If there is reason for optimism this time round, it is because the Cabinet Office has taken a leadership role, with senior commercial staff in line departments to be employed by the Government Commercial Organisation.

*Lateral recruitment* has always been problematic, and the available evidence suggests that over many years, there has been a loss of qualified procurement staff to the private sector. Gershon referred to this problem in 1999: 17% of procurement staff had left the public sector in one year, with three-quarters of these departing within 12 months of obtaining formal qualifications.<sup>73</sup> In a report on the procurement of ICT services in 2013, the Public Accounts Committee noted:

. . . we are concerned that key skills are being lost, with some staff using government as a stepping stone to a career in the private sector. Incentives will need to be in place to retain those people with the skills government needs.<sup>74</sup>

The Government Chief Commercial Officer has had some success in recruiting private sector executives with commercial capabilities, negotiating more flexible terms and conditions, but it has still proven difficult to attract, reward and retain experienced people.

*Career paths:* The Government Procurement Service was established in 1999 as a cross-government network designed to bring together around 1,500 officers across central government departments and agencies 'with the aim of creating a professional discipline through a set of competencies, training and skills development, and a career path'.<sup>75</sup> But the OGC found it difficult to create the sense of a collective identity across government. Five years after its formation, the NAO reported that only a minority of procurement staff had joined the GPS, and only a minority of departments were encouraging them to do so.<sup>76</sup>

The Cabinet Office is now making yet another attempt, with the intention of using the Government Commercial Organisation to serve as the heart of a network across government and in this way to offer the hope of an ongoing career in the commercial service.

To a significant extent, the development of the procurement capabilities has been constrained by the lack of published research on the variety of tools and models available. For example, there is no readily-available literature on what aspects of competition and contestability deliver better value for money (when done well), or how

different procurement approaches and incentive arrangements impact on service delivery. It is difficult to see how the discipline of procurement can significantly progress until there has been a much deeper investment in understanding how it works.

### *Contract Management*

There have been a succession of reports over the years which have warned about the failure to allocate appropriately skilled people to the management of service contracts, and the risks involved in moving staff responsible for contract management around too often.<sup>77</sup> When the NAO reported on the Home Office and the Ministry of Justice in September 2014, it concluded that, compared with procurement, contract management had carried low status, and there was limited understanding of what best practice involved. Many departments were struggling to recruit and retain experienced contract management staff.<sup>78</sup> The former director of commercial and contract management in the Ministry of Justice agreed, acknowledging that, 'while we put an awful lot of effort into procurement, contract management hadn't had the same level of focus and investment'.<sup>79</sup>

For a long time, contract management was not identified as a distinct capability separate from procurement, a dangerous mindset since it confused two completely different functions.<sup>80</sup> That has changed over time, but lately it has been seen as a form of commercial capability.<sup>81</sup>

The creation of the Government Procurement Service as an agency within the Cabinet Office in 2011, and the intense focus on category management and the standardisation and centralisation of government purchasing, may have weakened the emphasis on contract management at the centre of government. When the NAO reported on the new arrangements in February 2013, there was confusion as to whether the GPS or line departments were responsible.<sup>82</sup> The following year, it observed that: 'the Cabinet Office has focused on using government's collective buying power to make savings, rather than improving individual departments' contract management':

Traditionally, the procurement profession has had a low status in the civil service, while contract management has been seen as low status within the procurement profession.<sup>83</sup>

The fundamental importance of contract management had been rediscovered following the controversy surrounding several high-level contracts in the Ministry of Justice. A cross-government review of 28 major contracts found some examples of good practice in contract management, but 'the Review's overall conclusion is that in the majority of contracts there are weaknesses, some of which are significant, in the way these contracts are managed'. These included:

- A lack of senior level engagement in overseeing ongoing management of 9 of the contracts.
- Excessive numbers of KPIs, and an over-reliance on self-reporting by suppliers in 22 contracts.
- Weak approvals processes for contract changes in 10 of the contracts.

- A material gap between the numbers and capability of staff allocated and the level of knowledge and capacity actually required to manage 17 of the contracts.<sup>84</sup>

The Ministry of Justice commissioned its own review of contract management across a sample of 15 contracts with a total value of £425 million per annum. This also revealed 'longstanding and significant weaknesses in contract management' within the department.<sup>85</sup>

The rediscovery of the importance of contract management is welcome, but the focus has been overwhelmingly on the commercial aspects of this function. Government Commercial Operating Standards include a section on contract management, but it is largely concerned with performance reviews and commercial competency.<sup>86</sup> When the Public Accounts Committee focused on this question in 2013, the Cabinet Office responded by pointing out that it was:

- keeping a central record of strategic suppliers' performance across government, allowing action to be taken;
- setting and publishing minimum standards for supplier reliability based on past performance;
- requiring bidders to obtain certificates of past performance from both public and private sector clients.<sup>87</sup>

Based on the comments made by survey participants, it appears that some departments and agencies have interpreted enhanced contract management as requiring an aggressive application of financial abatements whenever suppliers depart from the strict terms of the contract.

The emphasis on the commercial aspects of contract management is long overdue, but there is a great deal more to the successful management of a contract than performance reviews and financial penalties. In particular, such an approach is likely to overlook the challenges involved in ensuring that two autonomous organisations work together, and underestimate the significance of the human relationships in making sure that organisations cooperate to deliver better public services.

In her report for government on 'the public service industry' in 2007, Dr. DeAnne Julius recognised that the appointment of commercial directors in departments and agencies would be insufficient to address ongoing questions of delivery. She recommended the appointment of a 'Director of Service Delivery' in all departments and local authorities with a substantial service delivery function – whether services were delivered through contract or in-house.

Their involvement would extend through the full commissioning cycle – not just the initial procurement – and they would be the high-level client interface when problems with service delivery arose. They would also ensure that their procurement and contract monitoring staff receive adequate training, supported by OGC and DCLG to accelerate 'learning by doing' and sharing of experience.<sup>88</sup>

This might not have been a practical solution, but she did understand that commercial directors have only a limited contribution to make to the ongoing challenges of service delivery.

The two pages of 'Contract Management Principles' published by the Crown Commercial Service are welcome, but they are no substitute for a deep understanding of how contract management works in practice. Once again, it should be noted there is not a readily-accessible literature which explains how the ongoing delivery of complex public services under contract actually works, and without this, it will be virtually impossible for contract management staff to learn their craft.

### *Commissioning*

It was around the year 2000 that policymakers and public service providers in the UK first began to realise that there was a stage prior to procurement which was often overlooked, where key strategic issues had to be resolved. Over time, this has come to be referred to as commissioning, although it was not until January 2013 that the government launched the Commissioning Academy 'to bring together senior commissioners from across the public sector to learn from the example of the most successful commissioning organisations'.<sup>89</sup>

While commissioning has its roots in procurement (among other things), it has much broader application. It has been defined as the process through which delivery agents are given the authority (and the resources) to deliver. What is new about this approach to the hand-off from policy to delivery is the attention given to the selection and prioritisation of outcomes, the translation of those outcomes into measurable objectives, the creation of space for frank conversations over the resources (people, money and time) allocated for the delivery of those objectives, the effective delegation of authority that will enable management to deliver, the measurement of performance, and the development and application of a consequences regime that is stable, predictable and proportionate.

The commissioning approach has placed a great deal of emphasis on the exploration and development of alternative delivery models – not just private and not-for-profit providers, but social enterprises, public service mutuals, public-private joint ventures, social impact bonds, management insertion (for example). In the UK, there has also been a focus on market engagement, although in overseas jurisdictions that have adopted commissioning, there has also been greater emphasis on system design and stewardship.

From its inception, the UK Commissioning Academy was focused on bringing together senior commissioners to learn from their peers. Its ministerial mandate did not provide authorisation to undertake research into good commissioning practice, or to explore the different applications of this approach across different services. After operating under the umbrella of the Cabinet Office for four years, the Commissioning Academy was recently merged into the Public Service Transformation Academy, and is now operated by an external provider.

As a result, the discipline of commissioning has not received the attention at the centre of government that it has in some overseas countries. National and provincial

governments in Australia, Canada and New Zealand have all been exploring the contribution that commissioning can make in transforming the relationship between policy and delivery. The New South Wales state government, for example, has established a Commissioning and Contestability Unit and released a formal policy document and guidelines.<sup>90</sup>

It is possible that the UK government's focus on commercial capabilities has contributed to the relative neglect of commissioning capabilities in central government.

### *Market Stewardship*

The importance of engaging with the market to understand industry capability and manage supplier expectations has long been understood. In writing about local government contracting in 2001, Sir Ian Byatt warned of the need for up-to-date information on potential suppliers and innovation in supply, and the need for local authorities to indicate their requirements to the market at an early stage and to understand suppliers' commercial requirements.<sup>91</sup> Several years later, the NAO developed the same theme:

Departments should have sufficient knowledge of how supply markets for specific goods and services are organised. They need this to assess the level of competition they can reasonably expect to attract for their business and to adjust their contract strategy accordingly. They also need good information on the relative performance of existing and potential suppliers and the resilience of their supply chains which might impact on the quality of service they provide.<sup>92</sup>

More than a decade later, providers still report that departments and agencies struggle with early engagement. While procurement notes published by the Crown Commercial Service acknowledge the need for effective pre-market engagement, it is by no means commonplace or well-done. As industry figures explained:

The Civil Service don't get out and speak to providers – they don't know the market.

Tenders are coming out that don't allow us to show our capability. The specifications are locked down so that there is very little scope for innovation. Government needs to consult with industry prior to tender-writing, to understand the art of the possible.

Government should engage with industry on what the future looks like.

Beyond market engagement, a number of government reports have argued that government needs to accept responsibility for shaping and managing these markets. In his 2004 Efficiency Review, Sir Peter Gershon argued that:

. . . strategic management of major supply markets is not well established and consequently there is an underdeveloped understanding of factors such as the impact of new policies on the supply side, dynamics and characteristics of the supply markets, and the efficiency of these markets.<sup>93</sup>

Around 2005-2006, there was some excellent work done by departments and agencies in the analysis of particular market sectors.<sup>94</sup> Today there seems to be little awareness of this body of research, or the uses to which it might be put in shaping and better managing the structure and culture of delivery.

From 2012, the Institute for Government published a series of excellent reports on market design and stewardship, but it does not seem that this work has been built upon systematically.<sup>95</sup> Occasionally one stumbles across sophisticated guidance documents, but it is far from clear that they have made a difference on the ground. One example of this are the framework documents published by the Department of Health, the Local Government Association and the Association of Directors of Adult Social Care on the management of the social care market, including guidance on assessing market and provider sustainability.<sup>96</sup>

Unfortunately, no government agency has clear responsibility for market stewardship in this sector, and both the residential and home care markets are currently unsustainable. And once again, there is very little research being done in this field, and there has been no sustained effort anywhere in government to learn the lessons and to disseminate these across government in a disciplined way.

## 2.6 Contractibility

As noted earlier in this report, questions have been raised at a senior level in government, as to the suitability of contracting for the delivery of complex public services. The suggestion is that contracting is capable of being used for buying highly commoditised goods such as paperclips, but little more. Looked at in this way, the key to the future success of the market lies not so much in capability as suitability.

### 2.6.1 Incomplete Contracts

This view of contracting has received some support following the award of the 2016 Nobel Prize in Economics to the British-born economist Oliver Hart, whose work on incomplete contracts asserts that the separation of ownership and control is problematic when services are difficult to specify in advance. In a paper published in 2003, Hart used prison contracting as an illustration of his thesis:

. . . ownership does matter when contracts are incomplete: the owner of an asset or firm can then make all decisions concerning the asset or firm that are not included in an initial contract (the owner has 'residual control rights').

Applying this insight to the privatisation context yields the conclusion that in a complete contracting world the government does not need to own a firm to control its behaviour: any goals – economic or otherwise – can be achieved via a detailed initial contract. However, if contracts are incomplete, as they are in practice, there is a case for the government to own an electricity company or prison since ownership gives the government special powers in the form of residual control rights.<sup>97</sup>

When they announced Hart's Nobel Prize in October 2016, the Royal Swedish Academy of Sciences linked their decision to the recent announcement of the Obama

administration that it was terminating its contracts for the management of custodial institutions in the Federal Bureau of Prisons.

The problem with Hart's thesis is that in the UK and Australia, responsibility for the management of some prisons has been contracted to private providers for almost 30 years, with a great deal of success and few significant failures. Indeed, a body of academic literature has emerged which argues that the process of designing, negotiating and managing contracts has contributed a great deal to the policy and practice of performance management within the wider prison systems in these two countries.<sup>98</sup> As it turns out, the vast majority of the outcomes involved in managing a well-performing prison can be specified in advance as well as measured (although work is still underway on the objective of reducing reoffending, which has only recently been added to the list of key outcomes).

Hart has had a significant impact on the understanding of public service contracting by academic economists. Unfortunately, this has weakened their appreciation of the challenges involved in contracting for complex services, even where researchers have been granted extraordinary access to public officials and private executives responsible for the procurement and execution of major contracts.<sup>99</sup>

One of the problems with this view of contracting is that it divides the field of potentially contractible services into the known ('paperclips') and the unknowable (complex public services) – or more strictly, the readily specified and the unspecifiable. It excludes a vast middle ground – the unknown but potentially knowable – where, done well, commissioning and contracting have a huge amount to contribute.

One of the great benefits of commissioning is that when it is done well, policymakers are obliged to be clear about their intended outcomes and (given scarce resources) to prioritise them, to specify how success will be measured, to allocate resources capable of delivering those results, to delegate authority to identified delivery agents, and to commit to an intervention regime should the intended results not be delivered.

This is necessarily a voyage of discovery, and experience has shown that (done well) the process of negotiating and executing a contract is useful in turning the unknown (and the hitherto unspecified) into the known (which is capable of specification).

In the prisons sector, it is interesting to note that the original report commissioned by the Home Office from Deloitte Haskin and Sells in 1988 – at a time when the prospect of prison contracting was first being considered – explicitly refers to the role that contract specification would play in defining prison regime and standards across the entire system:

. . . contracts would set, for the first time, enforceable standards of security and regime. . .

There is [currently] no consolidated document outlining Prison Department policy on the conditions under which remand prisoners are kept. We therefore used a number of individual documents as a basis for constructing a list of areas for which standards would need to be considered. . .

Where possible, we propose that standards should relate to results to be achieved (outputs) rather than to resources or methods to be used (inputs).<sup>100</sup>

Given that public service contracting is often a process of discovery, it is important that government employ appropriate contractual tools. A highly transactional form of contracting might be suitable for the procurement of paperclips through an e-auction, but it will not be appropriate for complex human services. Contract form must follow service function.

#### 2.6.2 Control

There is another reason why contracting might not be regarded by ministers and senior civil servants as a suitable vehicle for the delivery of public services: control.

A number of survey participants mentioned this in passing, but one – a former civil servant who had been the commercial director for a large government department – thought that it was central to the sector's recent difficulties:

While governments say that they want to focus on outcomes, in practice, their day-to-day talk is all about inputs. They feel that they can control inputs, like the colour of the wall. If the system focuses on outputs, they feel that they have lost control, especially ministers. We need to be frank about their ability to transpose policy into outcomes. Ministers and civil servants say they want a market, but then something odd happens – they feel like they are out of control.

Some of the unhappiness with PFI contracting lies in the way in which it revealed and specified in advance the true cost of maintaining assets, and constrained the government's ability thereafter to defer spending on repairs and maintenance. When PFI was launched, this was listed as one of its great virtues. It was well-understood that, over many years, governments had compromised the quality of health and education services through the repeated deferral of spending on such intangibles.

In clarifying outcomes and authority, resources and results, accountability and consequences, contracting serves to substantially increase the leverage of policymakers and funders in the delivery of public services. One of the ways in which it does this is by stabilising the policy and funding environment within which front-line managers operate, enabling them to make better-informed decisions about delivery. Government retains the ability to change the policy environment, but under a contracting regime, the financial consequences of doing so are obvious. Policymakers may still elect to reduce the amount being spent on maintenance or on the delivery of services, but they will not be able to blame providers for the consequences.

If this is not acknowledged, then contracting has little to contribute to the better delivery of public services.



### 3. What Might Be Done?

Some survey participants take the view that the shift from a relational to a highly contractual market is irreversible, that there is no way of overcoming the loss of trust which has emerged over the past five or six years.

You can't put the genie back in the bottle. Contracts are contracts now. There has been a one-off reset – contracts are more transactional and will be treated much more seriously now.

Others take the view that markets have cycles, and that the pendulum will eventually swing back to a more relational and trust-based model. This might be true, but the evidence from history and from international markets is that the cycles might be very long. In the ICT sector, there is a view that government will eventually have to embrace the digital revolution, and that it is only a matter of time before it engages in a more mature way with the industry.

The alternative view is that the market for complex services is unsustainable if questions of trust are not addressed and more appropriate contractual models are not employed. This was the most widely-held view among survey participants, and it is the approach adopted in this report.

#### 3.1 What Government Might Do

The primary responsibility for the political and commercial sustainability of the public service economy lies with government. This is government's supply chain, and if because of the way in which the system is designed and individual suppliers are managed, core public services are compromised and government's brand is damaged, then ultimately that is government's fault.

Of course, providers must be intimately involved in this process, but there is little that they can do if government does not take the lead, if government does not acknowledge its responsibility for the design and stewardship of the market.

##### 3.1.1 Supply Chains and Markets

The starting point must be an acknowledgement on the part of government that, when it comes to complex public services at least, it is a producer rather than just a buyer of services. The Crown Commercial Service has acknowledged that 'suppliers are an extension of government's business' – although in recent years, this way of thinking about government's suppliers has not been paramount.

The use of the term 'market' to describe the systems through which external providers are engaged has not been without its difficulties. When they hear this word, most people (including economists) think of the markets for commodities where quality is regulated by brand and price is set through exchange. Few public service systems, even when they include a significant element of contestability, are like that.

If government is overwhelmingly a producer rather than just a buyer of public services, then it must have a very different relationship with its supply chain. This distinction – between buying and commissioning, between markets and supply chains – was well-made in a report published by RUSI in 2015 about the ‘Whole Force’ approach adopted by the UK Ministry of Defence.

Within much of the business literature there is a clear distinction between commercial entities which are buyers of goods or services – therefore meeting a need, or selling-on into the marketplace – and those which are manufacturing entities that blend raw materials, technologies, production know-how and specific components to generate and, thereafter, support a particular product or service. . .

When the individual consumer opts to buy a television or even selects a builder for a home extension, he or she does not normally worry about the impact of the choice on supply chains or even how the television manufacturer selects its suppliers. The focus is on the price, performance and reliability of the final product and the consumer holds the brand manufacturer responsible for all the features of the product, regardless of where they came from: should the Toyota-owner ever press the door opener on the key fob and find the car stayed locked, he or she would not observe that Toyota must have chosen a poor lock supplier. Indeed, some officials and political figures associated with defence view the MoD as essentially a purchaser of goods and services from the private sector for deployment to meet defence and security ambitions. . .

A contrasting view underlines that the MoD is responsible for ‘producing’ things and not just ‘using’ things. The MoD’s own reporting and performance-measurement systems show that it is responsible for the generation of outputs (force elements able to act at varying degrees of notice) and outcomes (deterrence and success on operations). The MoD’s central task is to produce UK defence policy and then to direct the generation of military capabilities that support the delivery of that policy. . .

Under this approach, the MoD, and the armed forces and agencies within it, are significantly analogous to manufacturing organisations, bringing together all the diverse elements required for usable and sustainable defence capability. Some of those elements they generate within the governmental defence sector while (many) others are sourced from outside.<sup>101</sup>

In fact, governments draw upon a wide range of competitive and contestable systems for their goods and services. Most commodities – computers, office furniture, paperclips – can simply be bought or leased in the market. Category management is ideally suited in such cases.

Increasingly, governments around the world are offering choice in public services through the use of individual budgets and other voucher-style arrangements. Service beneficiaries are funded, in whole or in part, by government, but they are able to choose from a variety of approved public, private or nor-for-profit providers in a system that bears many of the characteristics of a market. However, since these are public

services, designed to improve social outcomes and financed by the taxpayer, government has an essential role in certifying suppliers and managing the conditions under which transactions take place.

In some cases (such as criminal justice and defence), governments commission goods and services for which there is no legitimate private market and would not otherwise be produced. These arrangements are more like a corporate supply chain, and government must actively develop capability amongst its suppliers. It will also want to ensure that there are several different sources of supply so that it is not held to ransom through private sector monopolies.

Government contracts with private firms for the supply of back-office services – ICT and other business processes, hard and soft facilities management – in much the same way that private corporations do. These relationships are complex and ongoing, and they depend for their success on thoughtful selection and careful management.

Governments have also designed clearing-houses for matching students and school places, medical students and hospital internships, and the donors and recipients of kidneys – these systems employ some of the characteristics of markets, but not price.

And they commission frontline public services from public, private and not-for-profit suppliers – in these cases, providers are dealing directly with the public, and government will usually select its suppliers through competitive tendering and exercise a great deal of control over their ongoing management.

The difficulty in using the word ‘market’ is that many economists think that governments should apply the principles of competition economics, which have been developed for the regulation of commodity markets. Insufficient attention has been paid to the variety of delivery systems, or to the very different needs of different beneficiaries of public services.

And, having discovered that government relies on competitive tendering to select its buyers, procurement experts draw on auction theory for the design and management of tendering processes. Not enough thought has been given to the differences between the kind of procurement systems that will be suitable for allocating spectrum licences and purchasing copy paper, and those that will be appropriate in selecting the providers of social services to vulnerable individuals.

It is fundamental to the establishment of a more sustainable market for complex public services that both sides agree that they are significantly different from the commodity markets with which politicians, policymakers and the public-at-large are more familiar.

### 3.1.2 Understanding Alternative Market Models

Government must make clear at the highest level that the procurement and contract management tools that are appropriate for buying highly commoditised, easily specified goods and services are not appropriate for commissioning complex support services and front-line human services.

It is now evident that there were significant savings to be made from greater standardisation and centralisation in the procurement of basic goods and services. There was a need for a more commercial approach to contract management. And, in

the wake of the global financial crisis and the focus on repairing the budget, it was inevitable that there would be a more intense focus on price. But insufficient attention was given to the impact that these reforms would have on the delivery of complex public services and ultimately on the sustainability of the market if these settings are maintained.

The tension between price and quality in government contracting is not new. There has been a debate over contracting models going back to the 18<sup>th</sup> century at least. On one side, there were those at the centre of government who were primarily concerned about economy; on the other, those in the field who were focused on quality and reliability.

But there has also been a difference of world view between those, like Jeremy Bentham, who believed in primacy of contract design and the motivating effects of financial incentives, and those, like David Hume and Edmund Burke, who argued that in the delivery of public services, internal motivation mattered.<sup>102</sup>

These differences are evident in the debate over public service contracting today. Those close to the front line are much more sensitive to the impact that benchmarking and low-price bidding have on staff numbers and service quality. Those who deliver human services to vulnerable members of the community are more aware of the need for a 'public service ethos' in working with these individuals.

Research by the European economist, Bruno S. Frey and his colleagues, suggests that there may not be a balance between these two approaches to contracting: highly contractual performance regimes, with intensive monitoring and strict enforcement seem to work well for some services, while more relational models, with a considerable reliance on trust, work with others. There may be no middle way.

Frey and his colleagues concluded that performance is enhanced when enforcement is strong or weak, but not in between. Their explanation is that trustworthiness (which does very little work under a strong enforcement regime) may be crowded-in with weak enforcement because of the heavy reliance on trust, and crowded-out with medium enforcement. Low-intensity enforcement may encourage the entry of principled providers, while medium-intensity enforcement may open the market to less trustworthy players without mitigating the associated risks. Frey has also argued that strong financial incentives may be counter-productive where intrinsic motivation is important to successful delivery of a service.<sup>103</sup>

This suggests that government needs to develop a more sophisticated understanding of the characteristics of different services, the extent to which outcomes and outputs can currently be specified and performance measured, the ability of providers, in-house and out-of-house, to deliver improvement and the range of contractual tools that are likely to work best given the current state of the market. It must be able to take an informed view on contract size and duration, the relative importance of price and quality, the intensity of the performance regime and the associated rewards and penalties, and so on. At present, it does not have these capabilities. As one survey participant commented:

Government is increasingly short-term. The forms of contract being used don't justify the investment in partnership and skills.

Some markets are low-maintenance, with commissioners having little more to do once the procurement has been completed and the contract signed. In other cases, the market is more like a corporate supply chain, and public officials will be actively engaged in developing suppliers in the early stages of system development and managing them throughout the life of the contracts. Government must be able to distinguish between these different kinds of delivery systems, and adapt its market stewardship activities accordingly. At present, it does not have these capabilities either.

This is in spite of reports by the Office of Government Commerce from as early as 2003, arguing the need for 'a much more intensive and open dialogue with suppliers at all stages of the procurement', in part so that industry has a clearer understanding of government's future intentions, and in part so that government has a better appreciation of market capability.<sup>104</sup> A number of executives interviewed for this survey observed that civil servants don't get out and speak to providers enough, with the result that they don't know the market. The large suppliers acknowledged the Crown Commercial Representatives were engaging with them in a more strategic way, but it is clear that this has not gone far enough, and it is still not commonplace in line departments and agencies.

Industry is strongly of the view that government should reconsider the contractual and procurement models which have emerged in the public service economy over the past five or six years, in particular the way in which those tools are being used in commissioning complex public services. If government persists in using models that are only suitable for buying 'paperclips', then over time, government will cease procuring complex services.

Government must learn to distinguish between those markets that have matured to the point where they are capable of commoditisation, and those where the complexity of or uncertainty about the services in question and/or a general lack of understanding or expertise on the supply side requires a less transactional approach. The need for such a distinction was recognised by Sir Ian Byatt as long ago as 2001, in his report on local government procurement:

Well-established competitive markets exist for many of the routine goods currently bought by local authorities. There is scope for improvements in procurement, particularly by reducing transaction costs. E-procurement has an important part to play. . .

Where there are new markets for large and complex services, local authorities will need new capabilities of contract design and contract management.<sup>105</sup>

Sixteen years later, government does not currently possess the ability to distinguish between those services which can operate reasonably well under a highly transactional and aggressively price-based model, and those that require a more relational and trust-based approach.

It takes years for a large organisation to develop the skills required for the deployment of effective relational contracts across its supply chain, so it will take time for any such change to take effect. It has been argued that this was one of the reasons why in the 1980s, General Motors had difficulty in imitating the production techniques that had been developed and so successfully deployed by Toyota:

GM's history of adversarial relations with its blue collar workers and suppliers, its reliance on an operating model that assumed there was very little need to exchange knowledge across either firm or functional overlap and its muddled and unaccountable internal processes made it difficult to build the credibility fundamental to effective long-term relationships. Moreover even after the firm had recognized the importance of adopting techniques like continuous improvement and cross-functional communication, it took some years to understand the nature of relational contracts that would be needed to diffuse them within the organization. Managers accustomed to governing by fiat appear to have found it difficult to understand the potential benefits of discussion and collaboration.<sup>106</sup>

As suggested in section 2.3.3, if it is interested in rebuilding industry's trust in the market, government might also consider a separation of its responsibilities for market regulation from its role as customer.

Guidance documents insist that government expects suppliers to speak up when a project is unlikely to succeed because of poor behaviour on the part of civil servants or a lack of good governance. In practice, that does not generally happen.

While there is growing respect for the professionalism of the staff employed by the Crown Commercial Organisation, the legacy of a highly adversarial approach to procurement and contract management, pursued by the Cabinet Office and the Crown Commercial Service in recent years, remains. Some companies have gone to their Crown Representative or to the Chief Crown Commercial Officer when they encountered difficult customers, but this was not regarded by some survey participants as an ideal solution.

The suggestion was made of some kind of 'ombudsman' to whom companies could complain when they encounter such behaviour. Unfortunately, this might encourage more gaming behaviour on the part of suppliers in the form of unjustified complaints. However, if government wishes to address this conflict of interest between its role as market player and market regulator, then serious consideration needs to be given to this question.

### 3.1.3 Rebuilding Trust

How does one reboot an entire market? In theory, this might be possible if customers and suppliers could return to using simpler and better understood forms of contracting, focused on public services where the relationships between inputs and outcomes are better understood. In reality, that is probably not possible.

Some attention has recently been given to building a code of conduct for the public service sector, but overwhelmingly this relates to government's suppliers and not to

procurement officials and those involved in contract management. And in any case, it is unclear what difference it will make in the field.

Working in collaboration with government, the ICT sector introduced a Code of Conduct in the 2004 to regulate providers' conduct. There was talk of the code being used as a quality assurance mechanism and incorporated into the Expression of Interest process. It was supported in principle by the Office of Government Commerce but it was (for example) utterly ignored in the NHS National Programme for IT, one of the largest ICT procurements of the time.

A more practical solution, suggested by a senior civil servant in the course of this review, might be to bring government and industry together to concentrate on rebuilding trust and resetting market conditions in one or two sectors. These would serve as small-scale experiments for testing different ways of resolving the problems, and by focusing on only one or two sectors at once, senior executives on both sides could be involved. However, if such a process were to succeed, it would require careful design.

It would be important to select the right test cases. The services in question should be relatively complex and/or close to the front line, so that there can be no suggestion that they were better suited to a highly transactional approach. It would be helpful if they were areas where contracting is already well-established, with a history of trust and a past reliance on strong relationships. However, they should also be services where it is acknowledged that there have recently been problems (on both sides). They should be services where there is a widespread belief that contracting will continue into the foreseeable future.

Participants should know that they are operating under a strong mandate from senior levels in government and industry. As far as industry is concerned, this might be organised through the BSA. Both sides should be clear about the objectives for each of the task forces.

The objectives should be: to identify and hopefully document recent and anticipated problems in these sectors, on both sides; to identify which of these issues matter and why; to explore alternative approaches; and to investigate how to make the transition from one market model to another.

It is vital that in selecting the participants and in developing the early work programme, that there is a high level of personal trust and close communication between members. Each task force should be chaired by an independent and widely-respected figure who is committed to establishing and maintaining this trust and communication.

Task force members should be senior figures with considerable experience in public service contracting, and the authority to speak on behalf of their organisations. They should all be of broadly comparable seniority, and they should give a personal commitment to the work of the task force, with no room for substitutes. Ideally, the membership should extend beyond the companies and agencies directly involved in the services in question.

Each of these task forces should be supported by a working party of somewhat more junior executives and officials who would undertake the detailed work.

As mentioned elsewhere in this report, government and industry have somewhat different understandings of trust and integrity, and it would be important that, in the early stages of the task force's work, an effort was made to explore and understand these differences.

It would also be important to ensure that participants in the task force and working group meetings were frank with each other, with participants acknowledging their own mistakes as well as identifying perceived issues on the part of others. It would be essential, however, that such conversation and research was directed to exploring the underlying issues, not the assignment of blame.

#### 3.1.4 Managing Price in Procurements

As discussed in section 2.1, public officials seem to find it difficult to avoid using competitive tendering as a vehicle for low-price procurement. While such an approach may be appropriate for highly commoditised services where quality is readily determined and there is little need for innovation, it is extraordinarily dangerous with complex public services. It often leads to 'winner's curse' procurement, where the successful bidder bids too low, resulting in a 'race to the bottom' in workers' terms and conditions, weakening service quality, undermining profitability and ultimately compromising the political and commercial sustainability of the market itself.

The industry has pleaded with government over many years, not to engage in low-price procurements. They are fully aware that they and their competitors will find it difficult to resist the temptation to bid, and that the industry may suffer as a result.

Ministers and public servants need to understand that, for a time at least, companies may be induced to act against their medium- to long-term interests. Concerns about profitability and corporate brand will not necessarily act as a natural brake in aggressive price-based procurements. But the fact that departments and agencies have continued to pursue lowest price, in spite of being told repeatedly that government's objective was best value, suggests that the public sector finds it difficult to take these lessons on board.

Needless to say, the tendency to low price procurement and the unfortunate consequences that follow are exacerbated where ministers openly declare that government purchasing systems are to be explicitly used to drive down cost. This is one of those issues where the private sector has very little to contribute – it is government's responsibility to understand the reasons why procurements so often favour the lowest price over value-for-money, and to introduce systems and processes to compensate for the bias.

It is acknowledged that from time to time, governments will take the view that they must significantly reduce public spending over the short term, and that civil servants will be obliged to implement government policy. Done well, competitive tendering can be a powerful tool for delivering improved value-for-money, but there is a question whether it can be safely used when governments are facing extreme financial stress.

### 3.1.5 Challenging Systemic Self-Deception

A number of governance mechanisms have been recommended over the years to deal with this problem. The most notable of these were the Gateway Reviews introduced by OGC in 2001 following Peter Gershon's review of procurement in central government. The planning and execution of major procurements were to be challenged at different stages, by a committee chaired by a person with no stake in the outcome of the project.<sup>107</sup>

Gateway Reviews have made an important contribution in challenging unrealistic assumptions, and they have since been adopted throughout most of the English-speaking world. They are similar to the 'black hat' processes employed by some private firms prior to making major investment decisions, which deliberately employ a devil's advocate to challenge the proponents' assumptions. However, there is evidence that 'black hats', internal due diligence processes and investment committees can fail even in the private sector, if a culture of robust challenge is not maintained. Governance solutions such as these cannot be relied upon if they are largely dependent on support from outstanding individuals in senior positions. Gateway Reviews have sometimes failed for the same reason.

The establishment of strong organisational boundaries between the policy and regulatory functions of government and the delivery agents has sometimes been used as a structural solution to this problem. This was implicit in the creation of distinct executive agencies throughout the late 1980s and 1990s.<sup>108</sup> The 'Next Steps' initiative quickly delivered some significant improvements, and contributed to the later development of Public Service Agreements. But as the Institute for Government has pointed out, over time, 'Next Steps' became business as usual, the quality of leadership declined and the discipline was lost. 'By the mid-1990s, it became clear that the framework agreements for individual agencies were not necessarily incentivising improvement in performance'.<sup>109</sup>

In defence procurement, there has been an attempt to address this problem of unrealistic expectations through the erection of a clear boundary between the customer and the supplier functions. In Australia, the Kinnaird and the Mortimer Reviews recommended the functional separation of the Defence Materiel Organisation from the department, with its establishment as an Executive Agency of government.<sup>110</sup> Here in the UK, the Gray Review proposed the separation and clarification of roles and accountabilities between the MoD centre and Defence Equipment & Support, with the suggestion that DE&S be established as a GOCO operated by a private firm.<sup>111</sup> Lord Levene approved of a strong customer-supplier divide in his 2011 report on defence reform.<sup>112</sup> In neither the UK or Australia were these recommendations fully adopted.

If it is organised properly, commissioning will do this same work of challenging the systemic self-deception. However as noted elsewhere in this report, commissioning is both a lever and a place to stand – commissioners must have the authority and the incentives to challenge as well as the capabilities. This is not to say that there always needs to be a separate commissioning agency, but it is fundamental that there is a distinct function (and hopefully, a recognised discipline).

If commissioners are well-trained and they are respected for being able to make a significant contribution to the ongoing relationship between policy to delivery, then they will be accorded the authority to challenge.

One model for what is being suggested here might be the Corps des Ponts et Chaussées, established by the French national government in 1716 to manage the concessionaires employed by government to construct its public works. With an associated school to train the engineers who would staff it, the Corps established a formidable reputation for professionalism and independence. The US Army Corps of Engineers was directly modelled on it, and the origins of cost-benefit analysis (and the marginal revolution in economics) lie in the work of the Corps des Ponts.<sup>113</sup>

In this case, a strong reputation for technical expertise endowed the engineers and proto-economists of the Corps des Ponts et Chaussées with the authority to challenge unrealistic demands made by the individuals and agencies responsible for policy and funding.

### 3.1.6 Understanding How Contracting Works

Some survey participants insisted that government and industry need to acknowledge when they get things wrong, and honestly explore what happened. The NAO has published excellent reports over the years on competition and contract management, but these are released into a highly adversarial environment, and the scope for learning and improvement is limited as a result.

Occasional government inquiries are not well-suited for this purpose either, since they have limited terms of reference, and they exist for only a brief period of time. There are relatively few academics who have dedicated themselves to the study of public service contracting: it is surprising, given the scale and the significance of the UK public service economy, that there has not been a great deal more research over the years.

Compared with the literature on the management of the firm, the applied literature on procurement, contract negotiation and contract management is quite small. A micro-economist is awarded the Nobel Prize for the theoretical analysis of prison contracting, while the operation of public service contracts in the UK over a quarter of a century remains largely unstudied. Auction theory and algebraic formulae are no substitute for field research and fail to explain many of the real-world problems encountered in government contracting.

The literature on market design and stewardship is smaller again. Alvin Roth was awarded his Nobel Prize for ‘the practice of market design’, and his work on matching markets is applied as well as theoretical. While he has popularised the concept of market design among economists, he is working with only one particular kind of market – the clearing house.<sup>114</sup>

In spite of the growing popularity of individual budgets and vouchers across the developed world, and a considerable literature about their use in individual sectors, there are only a handful of books which explore the architecture of choice-based markets for public services. This makes it difficult for civil servants charged with developing a voucher scheme in an entirely new service area.

For the most part, the literature on corporate supply chains is highly technical, and provides little guidance to policymakers charged with designing a supply chain for government.

Consideration should be given to the establishment of a centre of excellence somewhere in the UK for the applied study of public service contracting, and the design and operation of public service markets. This would work best if it was funded jointly by government and industry, and there was a clear commitment to the centre's independence and longevity. The objective should be to undertake detailed research into real-world markets, contracts and procurements, studying the experience of both sides, and extracting the lessons without laying blame on individual parties. It follows that for such an institution to work, it would need to enjoy the absolute trust of both government and industry.

One of the survey participants observed that if only a miniscule proportion of the money that has been wasted on flawed procurements and failed contracts in recent years were dedicated to such an institution, it would be well funded indeed.

#### 3.1.7 Building Capability

It has been argued in section 2.5 that government needs to build its capability in procurement, contract management, commissioning and market design and stewardship. The concept of 'commercial capability' is at the same time too broad and too narrow – it fails to recognise the lack of serious applied research in these separate fields, and it assumes that the necessary skills are primarily commercial in scope.

If government is serious about improving capability in this area, then it must give serious attention to the study and teaching of these four disciplines. There are precedents. The Major Projects Leadership Academy, based at the Said Business School at the University of Oxford, is one such example. It has quickly acquired a reputation for excellence. The US Defence Acquisition University is another.

### 3.2 What Industry Might Do

There are limits to what the industry can do to contribute to this process. This is government's supply chain, and government must decide the rules and the conventions that will govern these markets: if departments and agencies engage in aggressive gaming, they should not be surprised if providers do likewise. And because of laws which preclude collaboration among firms in bidding for contracts, there are constraints on the extent to which industry can respond collectively.

#### 3.2.1 Individual Strategies

Of course, individual companies must decide for themselves, independent of their competitors, how they will respond. Some providers are managing the risk by withdrawing from certain sectors – front-line services, social housing, social care, UK central government. Some have resolved to focus on their core competencies, being honest with themselves and their customers about what they do, and doing it well.

Most of them have improved their governance processes in an attempt to constrain 'bid fever'. Some are challenging their customers – spelling out the consequences of a race to the bottom. Most companies are taking stock much earlier in the procurement

process, deciding whether this is a contract that they would want to win. Some are investing heavily in systems and processes that offer the customer much greater visibility of their operations.

But if government takes the view that there is a vast pool of potential suppliers who can enter and exit the market at will, and if providers are unconvinced that their competitors have stopped participating in low-price bids and accepting uncommercial risks, then there is no guarantee that these individual strategies will work.

Most providers have been exploring new models of delivery – joint ventures with customers, and with SMEs and public service mutuals, management insertion arrangements, and service offerings which involve some investment in assets.

A number of survey participants noted that, even if government does set about to change the underlying market conditions and improve capability, there will be need for a short-term response to bridge the gap. Some providers believe, for example, that local government offers significant opportunities, particularly with the advent of regionalisation.

### 3.2.2 Collective Strategies

What might industry do collectively in order to help reset the culture and practices of the market?

#### *Conversations*

Providers have found it difficult to understand what has been happening at a market level, in part because they have only limited ways of conversing with their competitors. When the author spoke about these issues in the BSA's annual lecture in mid-2016, the response of the audience was 'Thank goodness someone is speaking publicly about these things'. This was possible, in part, because the author is an outsider – he is no longer involved in the industry and he no longer lives in the UK. This review is based on the same formula – a trusted outsider has met with a number of different providers one-on-one, making it easier for them to speak about their individual experiences.

Structured conversations can take place amongst commercial rivals without infringing the bounds of law or propriety – the author has participated in a number of such conversations over the years – but company executives find it extremely difficult to speak in any detail about their business models, or to acknowledge their mistakes, in front of their competitors.

There are ways of overcoming these barriers. Building on personal relationships of trust and the disinterestedness of sound academic research, KPMG and University College London (UCL) constructed a data club around 2009, to compare the performance of cleaning services in different hospitals. Operating bilaterally through a trusted middleman, public and private suppliers provided detailed information about their own performance, which was anonymised, analysed and published. Each participant was given a code by which they could identify their own services and compare themselves against the industry norm.

Public service providers might engage one-on-one with trusted intermediaries through anonymous and independent structures and processes, to construct a more finely-grained analysis of particular market sectors or large-scale procurements.

Some government inquiries have learned a great deal about the operation of the market by engaging closely with industry. A review in long-term capacity planning, conducted in 2002-03 for the Office of Government Commerce by Christopher Kelly, a former permanent secretary in the Department of Health, is one such example.<sup>115</sup> The review of the public service sector, conducted by Dr DeAnne Julius in 2007 on behalf of the Business Secretary, is another.<sup>116</sup>

The advantages of such information to government are obvious, but individual providers would also benefit from a disinterested and balanced account of market conditions.

### *Instruments*

Working through industry associations such as the BSA, providers may be able to develop tools that would assist them individually in overcoming some of the perverse incentives that emerge in the market.

For example, most companies undertake some kind of rough 'due diligence' of potential customers or procurements before submitting a bid or signing a contract. One survey participant thought that companies should investigate the nature of the customer's relationship with previous providers. Another suggested that as part of their due diligence, before responding to the request for proposals, companies should ask, 'Who is managing risk on your side?' There may be potential to work with different providers to unpack the key elements of a due diligence process, and to popularise the use of such an instrument by publishing the results.

Publications which explain the conditions that create a 'winner's curse' procurement and induce 'bid fever', and document the behaviour of different departments and agencies in the pursuit of risk transfer, might enable the industry as a whole to better understand the conditions which lead them to make unwise decisions in the course of bidding and negotiations. This is about building a shared understanding of the market, how it works, the different ways in which companies might respond, and the likely consequences of different responses.

The industry might also bring together a publication explaining to government what a good customer looks like, and why it matters. There has not been the opportunity to pursue this question in this review, but when this issue was raised with a number of survey participants, they responded: a good customer understands what they want; they are able to engage; they focus on value rather than cost, and they are a confident outsourcer, relying less on consultants. You recognise a confident customer, if was said, because they have fewer people at meetings. They take a long-term perspective, they focus on building trust, they want to build a relationship, they share the same values, especially around the treatment of staff. There is honest communication. They are tough but fair. They are not subject to the blame culture.

### *Narrative*

Industry must not expect government to tell its story. Civil servants will not defend any contract that has become controversial, no matter how well it has performed in the past. It is up to industry to understand the reasons why they have difficulty in getting their stories across. They must develop the narratives that will assist the politicians, the public servants and the public to appreciate their contributions, and the reasons why they do not always succeed. The following are some thoughts which emerged in the course of this review.

### *Attitudes to the Service Sector*

There is a fascination in politics and in the public debate with ‘things’ – primary production, manufacturing, computer technology (most notably apps, which also fall into the category of ‘things’). In the national accounts, services which do not involve the transfer of a physical object are referred to as ‘invisibles’. Despite the fact that services make up around 80% of the nation’s economy, they are still regarded in some ways as not quite real.

This is particularly a problem for business services, which are a relatively new entrant into the world of commerce. Based on the most recent study for the BSA, the business services sector makes up around 9% of the national economy and account for more than 10% of the nation’s jobs, with turnover valued at £263 billion.<sup>117</sup>

Because they provide support to other firms and to government departments and agencies, business services are even more invisible than other parts of the services sector, such as financial services, education or social care, where the public interacts with providers face to face.

The industry needs to develop strategies to make it more visible to policymakers and the general public, and in this it will find common cause with the rest of the business services sector. The Julius Review into the ‘public service industry’ was established by the Business Secretary in 2007 with this in mind, but of course, one government report was never going to be enough.

### *Attitudes to Profit*

For those providers who do deliver face-to-face public services, in hospitals and schools, prisons and probation, and even for some of those who deliver support services, there is suspicion and even antipathy to organisations that make a profit.

Providers believe that this mindset is widespread across government – ‘profit is seen as evil’; ‘profit is ugly’; ‘government is obsessed with profit’; ‘departments want to renegotiate when profit is high, but not when it goes the other way’. It has been manifest in a declared preference for not-for-profit providers, social enterprises and public service mutuals and hostility to large companies (although, in practice, the complexity of the services being contracted and the scale of risk transfer has required government to rely heavily on large, for-profit providers). Public service providers are by no means alone in this regard, and it is not a recent phenomenon.

Individually and collectively, the industry needs to confront these concerns about the profit motive. The public will understand that investors must be compensated for taking their money out of the bank, and they will accept the proposition that innovation brings

with it the risk of failure, and that companies must be encouraged to experiment with new ideas. At the same time, they must be reassured that companies will not make super-profits out of public services – open book accounting and gain-sharing mechanisms must be explained in terms the public can understand.

The industry also needs to demonstrate that it is capable of a ‘public service ethos’, and why it is in their interest, as well as the government’s, to employ staff who are motivated by public service rather than just profit. Every company has its own stories of outstanding public service: these need to be shared. Companies should be comfortable with telling each other’s stories. There is need to explain the difference between making a profit in order to deliver public services, and delivering public services in order to make a profit.

### *Attitudes to Delivery*

Amongst policymakers, there is little respect for those involved in day-to-day delivery, which is inevitably difficult and messy, whether it is undertaken by public servants or private employees. In spite of the enormously valuable work which they perform, those involved in delivering support services are often described as non-core or back office staff, and because their contribution is poorly understood, they are often targeted first in spending cuts.

Survey participants spoke of this in a number of different ways. In the NHS, one said, support services are seen as a Cinderella service. Another spoke of property management being a poor relation in the world of policy. Several commented on the lack of respect for maintenance.

The world of delivery is characterised by entropy, and the managers of front-line services struggle every day against the consequences of mission overload, scarce resources and human error. This is true whether services are delivered by public or private providers, but because public service providers specialise in delivery and because individual companies have brands that can suffer reputational damage, they are particularly vulnerable to criticism.

Industry needs to promote ‘the aura of grandeur about the dull routine of maintenance’ (to quote Eric Hoffer, the so-called longshoreman philosopher). This is a place where providers can find common cause with the unions – both have an interest in explaining the challenges involved in the successful delivery of services day-to-day, and the massive contribution made by staff who work in support roles. One example of this is the Health Service Journal’s recent ‘Inquiry on Maximising the Contribution of NHS Non-Clinical Staff’, where providers and unions worked together to produce a report in November last year entitled, ‘It’s Time to Pay Them Some Attention’.<sup>118</sup>

### *Attitudes to Management*

One survey participant noted: ‘A bit of a narrative has developed that the only way the private sector makes savings is by cutting terms and conditions.’ This is a longstanding problem for the industry: the author can remember senior civil servants and union officials making the same comment more than a decade ago. Another survey participant thought that ‘Contracting is seen as a zero-sum game – industry needs to

demonstrate that it can be win-win'. Another suggested that 'Government doesn't understand management'.

The industry could make a contribution to the understanding of the public service economy, in government and in the wider community, by using real-world case studies to explain the difference that good management makes in delivering more efficient and effective services.

One of the best examples of this was a study undertaken some years ago by a team of economists, of a vehicle maintenance and warehousing contract at a New Zealand Army base. The research began while the contract was still being phased-in, and the authors were allowed unprecedented access to management information and decision-making processes, including (for example) tender documentation, monthly contract reports and detailed information on labour costs.

In the workshop, for example, they discovered that while staffing levels fell, the number of full-time equivalents actually rose, since the uniformed personnel previously employed had also had military duties. Capital equipment was reduced, because of milling machines and lathes that had been under-utilised. There were a number of process innovations, with a new operational layout developed for the workshop floor which reduced coordination inefficiencies. As a result, the contractor increased output in the workshop by 28%.<sup>119</sup>

Providers do not regard these results as exceptional – they are the kind of reforms which they routinely undertake when they assume responsibility for a service that has not been market-tested before. But they will come as a surprise to many in government, particularly those who work in policy, who have no real idea of the difference that good management can make. The New Zealand study was unusual largely because of the access that the academics were granted, and thus its explanatory power.

The industry might organise a number of such studies. This kind of research would provide clear evidence of the *magnitude* of cost savings (a worthy outcome by itself), but more importantly, it would demonstrate *how* they were delivered. Consideration should also be given to studies which document the differences that competition and contracting made. One of the survey participants, who worked in the public sector for a time, observed that government often finds it incredibly difficult to change delivery. It was suggested that the industry needs to demonstrate how contracting can be used by government to assist in the process of change.

Finally, the industry should consider commissioning studies which demonstrate the ways in which contractors have helped departments and agencies to solve a range of problems, not just saving money. As one of the survey participants described it: 'We need to show that we are not just an ugly sister, where people can save a few bob'.

## 4. A Personal Conclusion

In the course of researching this report, I re-read a wide range of government reports and personal memoranda which I had collected in the years when I was deeply engaged in the UK public service market (1993 to 2011). One of the surprises was how often these same concerns had resurfaced over the years.

I was particularly struck by the following, from a brief on the state of the market, which I prepared in January 2003 for the Public Services Strategy Board, which had recently been established by the Confederation of British Industry:

These difficulties have been ascribed to the failure to articulate client needs clearly in advance, conflicts between multiple government agencies, greater intrusion of political considerations into bidding, excessive risk aversion, a bias towards low-cost bids rather than best value, unrealistic expectations about risk transfer, attempts to maintain intense competition down to final selection, a failure to understand the needs of the private sector, a lack of procurement skills in government, a lack of continuity in bid teams, and a failure to manage advisers.

Two and a half years later, a meeting of senior public officials and private sector executives was convened by the Chancellor of the Duchy of Lancaster and Minister for the Cabinet Office to address the question of market sustainability. The list of issues discussed at the meeting included the following:

- Provide greater certainty about the future direction of government policy and the political environment.
- Develop competition and contracting models that are politically sustainable (in terms of service quality, accountability and workforce issues).
- Develop models that are commercially sustainable (in terms of attracting new entrants, ensuring adequate market depth, providing sufficient visibility on forward opportunities, stimulating innovation and investment, avoiding unnecessary scale and complexity which tend to exclude SMEs, finding optimal contract length).

The difficulties that have surfaced in the public service market in the past five or six years are not new. They are certainly more acute than in previous decades, but the underlying issues are much the same. What has been different in recent years is the broader economic and financial climate, and the particular ways in which government has chosen to respond. Understanding this should make it easier for government and industry to appreciate the underlying causes of these problems, and to develop solutions that will be effective in the short-term and sustainable over time. At the same time, knowing that these issues have been encountered (and dealt with) before

provides ground for optimism that fundamental policy and market settings can be recalibrated to ensure that the public service market is politically and commercially sustainable over the medium- to long-term.

- Gary L. Sturgess  
31 March 2017

## Endnotes

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- <sup>1</sup> NAO, 'Commercial and Contract Management: Insights and Emerging Best Practice', November 2016, p.3. This is not entirely apples-for-apples since the £242 billion includes goods and construction, but services dominate, and particularly ICT, facilities management and professional services.
- <sup>2</sup> Ibid.
- <sup>3</sup> Alan Travis, 'G4S agrees to repay £109m for overcharging on tagging contracts', *The Guardian*, 12 March 2014.
- <sup>4</sup> Based on the average of the annual returns for the past five years, adjusted in several cases by information provided to the author by senior executives.
- <sup>5</sup> Isabelle Fraser, 'Serco chief cites his grandfather Churchill in plea for better prisons', *The Daily Telegraph*, 9 November 2016, p.8.
- <sup>6</sup> Crown Commercial Service, 'Mystery Shopper Progress Report 2015-2016', [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/553294/Mystery\\_Shopper\\_Progress\\_Report\\_2015\\_2016.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/553294/Mystery_Shopper_Progress_Report_2015_2016.pdf). Given how much government spends on procurement, the 233 complaints a year, even at the peak, reflect an insignificant level of engagement with the service.
- <sup>7</sup> United Kingdom Homecare Association, 'Evidence Submitted by UKHCA for the Community and Local Government Committee's Adult Social Care Inquiry', 22 August 2016, p.6
- <sup>8</sup> Care Quality Commission, 'The State of Health Care and Adult Social Care in England, 2015/16', HC706, 12 October 2016, p.43.
- <sup>9</sup> Rosemary Bennett, 'Crisis-hit care firms pay millions to owners', *Times*, 5 December 2016; Rachel Sylvester and Alice Thomson, 'Thousands of care workers earning less than the minimum wage', *The Times*, 13 December 2016.
- <sup>10</sup> Robert Lea, 'Mitie taken to the cleaners after homecare fiasco', *Times*, 22 November 2016.
- <sup>11</sup> NAO, 'Contracted-Out Health and Disability Assessments', HC609 Session 2015-16, 8 January 2016, pp.9, 10 & 38.
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- <sup>15</sup> Sir Michael Latham, 'Constructing the Team', Final Report of the Government/Industry Review of the Procurement and Contractual Arrangements in the UK Construction Industry', HMSO, July 1994, p.58.
- <sup>16</sup> Peter Gershon, 'Review of Civil Procurement in Central Government', April 1999, Section F.
- <sup>17</sup> Office of Government Commerce, 'Increasing Competition and Improving Long-Term Capacity Planning in the Government Marketplace', OGC Report to the Chancellor of the Exchequer, December 2003, p.12.
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- <sup>19</sup> NAO, 'Home Office and NHS England: Yarl's Wood Immigration Removal Centre', HC508 Session 2016-17, 7 July 2016, pp.18-20.
- <sup>20</sup> David Williams, '700 Jobs at Risk as NHS England Signs £330m Capital Deal', *Health Service Journal*, 11 August 2015.
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- <sup>22</sup> E.C. Cappen, R.V. Clapp and W.M. Campbell, 'Competitive Bidding in High-Risk Situations', *Journal of Petroleum Technology*, (1971) 23, pp.641-653.
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- <sup>25</sup> NAO, 'Contracted-Out Health and Disability Assessments', HC609 Session 2015-16, 8 January 2016, p.39.
- <sup>26</sup> Office of Government Commerce, 'Increasing Competition and Improving Long-Term Capacity Planning in the Government Marketplace', OGC Report to the Chancellor of the Exchequer, December 2003, p.16.
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extent – NAO, ‘Contracted-Out Health and Disability Assessments’, HC609 Session 2015-16, 8 January 2016, p.8.

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<sup>29</sup> Ministry of Defence, ‘Limiting a Contractor’s Liability and Indemnities’, August 2015, paras.4 & 5.

<sup>30</sup> *Ibid.*, para.19.

<sup>31</sup> House of Commons Defence Committee, ‘Defence Acquisition’, HC9, 5 February 2013, p.5.

<sup>32</sup> Stewart Macaulay, ‘Non-Contractual Relationships in Business: A Preliminary Study’, *American Sociological Review*, (1963) 28:1, pp.1-19, at pp.7 & 9. Macaulay’s analysis is much more complex than these brief passages might suggest. For a recent study of relational contracting in the private sector, see Monika Maria Möhring and John Finch, ‘Contracts, Relationships and Innovation in Business-to-Business Exchanges’, *Journal of Business & Industrial Marketing*, (2015) 30:3/4, pp.405-413.

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<sup>36</sup> ‘Chairman’s Overview’, ‘Government Procurement Service: Annual Report and Accounts, 2011/12’, HC417, London: The Stationery Office, 9 July 2012, p.6.

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<sup>47</sup> Richard Bacon and Christopher Hope, *Conundrum*, Biteback Publishing, 2013, Chapter 11.

<sup>48</sup> ANAO, ‘Offshore Processing Centres in Nauru and Papua New-Guinea: Procurement of Garrison Support and Welfare Services’, Report No.16, 2016-17, Commonwealth of Australia, 2016, pp.39 & 43.

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- <sup>70</sup> HMT, 'Transforming Government Procurement', January 2007, p.16.
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