

Discussion Paper 2: Public Private Partnerships

**National PPP
Policy and Guidelines**

**A Submission by
Serco Asia Pacific Pty Ltd**

1. Serco Asia Pacific

Serco Asia Pacific is a wholly-owned subsidiary of the global public service company, Serco Group plc. Serco has been delivering complex public services for more than 40 years, since it won the contract to design, build and operate Britain's ballistic missile early warning system in the early 1960s at Royal Air Force Fylingdales in the Yorkshire moors.

Serco is a service company, with more than 90% of its revenue coming from public service markets. Serco has been involved as a major stakeholder and equity holder in around a dozen infrastructure-based Public Private Partnerships (PPPs) since 1997, usually where the service elements are significant enough to enable the company to deliver considerable added value. However, it has also been involved in a multitude of complex public-private partnerships that involve significant transfer of risk, but without a transfer of ownership, such as the Atomic Weapons Establishment in the United Kingdom (UK).

In 2007, Serco had an annual turnover of almost A\$7 billion, employing well over 40,000 people in 30 countries around the globe, making it one of the largest public service companies in the world. One of the unique characteristics of the company is the wide range of market sectors in which it is involved, from defence and aerospace, to public transportation and traffic management, to social services such as prisons, education and managed health care. As a result, Serco has been exposed to a particularly diverse range of service models.

This submission is focused on the services associated with public private partnerships, both support and front-line activities, drawing on more than four decades of experience in the management of complex public services. It also draws heavily on Serco's deep experience in the UK market, where more than 800 PPPs have been signed, and where a variety of different models have been employed.

2. Building a world-class industry

Until the middle of the 1990s, Australia was one of the world leaders in the development of public-private partnerships. Queensland was the first jurisdiction outside of the United States to introduce private management of prisons and Victoria was ahead of the UK in using a PPP model to contract for prison design, construction, financing and operation. Australia pioneered the new generation of PPP toll roads almost 20 years ago and remained at the cutting edge in this field until very recently. New South Wales also pioneered PPP hospitals, a model that included clinical services.

While there may be some criticism of the models that were adopted in these early PPPs, it is beyond doubt that the Australian states were pioneers in this market. However, from the middle of the 1990s, Australian governments adopted a much more conservative approach to private sector involvement in the financing, construction and operation of public infrastructure, particularly social infrastructure, and the leadership role was taken over by the UK.

In the intervening years, the UK government has taken over the leadership of this market on the international stage, and for some years, UK Trade and Investment and the Lord Mayor (of the City of London) have worked with consultants, construction firms and investment banks to help them take advantage of the internationalisation of this market. With the publication of the Julius Report (see section 2), it is clear that the UK government is now proposing to do the same with the public service industry.

There appears to be a first mover advantage in public service markets. The first generation of PPP prisons were dominated by North American companies or to consortia that involved the same. In recent years, the leadership has been taken over by British prison management companies, in part

because the UK model is more transferable. When South Africa adopted the UK model for PPP prisons, it automatically provided an advantage to UK prison management companies.

Australia has had a first mover advantage in the market for PPP toll roads, with both Macquarie Bank and Transurban taking advantage of the Australia's leadership to enter major overseas markets. Policy makers from the United States have visited Australia on numerous occasions in the past couple of years to study our model.

If this analysis is correct, and the market for public services and PPPs is internationalising, and there is a first mover advantage, then Australian governments are placing our business leaders at a significant disadvantage in not showing policy leadership in relation to PPPs.

3. Infrastructure services

As a service company, it is unsurprising that Serco would focus on the ongoing management of PPPs, rather than construction or financing. However we believe that there are advantages to government in focusing on the ways in which facilities will be managed over the course of their lifetime, rather than looking primarily at the physical asset itself.

In Serco's experience, the services element of a social infrastructure PPP accounts for 30–60% of the net present value of the project. In the prisons sector, where the provider is typically responsible for all front-line services, the proportion is in the order of 60%. In the case of hospitals, where the private sector's role is confined to support services (usually both hard and soft Facilities Management but not clinical or para-clinical services), the proportion varies from one-third to just short of half the total net present value, depending on scale.

This is a strong reason why government should focus on infrastructure **services**, rather than just the physical infrastructure, particularly in the case of social services, where human interaction is central to delivery. As Infrastructure Australia's Discussion Paper 1 expresses it, 'infrastructure does not matter for its own sake: it matters because infrastructure can play a fundamental role in determining whether Australia meets its economic, social and environmental goals.'

There would be benefits for Australian governments if PPPs were employed as part of a much wider public service reform agenda. In July this year, the UK Secretary of State for Business released a report on the scale, scope and growth of the public services industry in the UK – known as the Julius Report, after its author. In 2007/08, the revenues of the private and voluntary sector providers of public services was £79bn (around 6 per cent of GDP), generating £45bn in value-add, and employing more than 1.2 million people. Moreover, since 1995/96, the industry had grown at an average annual rate of 5.4 per cent, in real terms.¹

In several other OECD countries (including Australia), the public service industry comprises a similar proportion of GDP. What is striking about the UK is the wide range of sectors where the private and voluntary sectors have been involved, the diversity of business models that have been employed and the extent of risk transfer.

UK government has benefited in several ways from having PPPs nested within a broader public services market: (i) it has resulted in a deeper market, particularly where services are concerned, with a wider range of opportunities attracting international providers, as well as companies from other sectors; (ii) the public sector has found it more worthwhile to invest in high-level skills in complex procurement, market design and contract management; and (iii) models have been adopted from the wider market, so that PPPs have found it easier to evolve over time.

4. PPPs are a procurement tool

We submit that public private partnerships should be used as a tool for better procurement and management of physical infrastructure and the associated services, rather than as a financing tool. While private finance provides an important discipline in terms of risk transfer, PPPs should not be used as a way of shifting capital expenditure off budget (unless there has been a commensurate transfer of risk).

With rare exceptions, the Australian states have been conservative in their accounting treatment of public private partnerships, and Serco has always endorsed this approach. In our view, public engagement with the private sector should be driven by long-term value considerations, rather than short-term concerns.

As a result, the current uncertainty in financial markets should not be seen as a reason for not proceeding with PPPs. Indeed, given the emphasis that must now be given to productivity and efficiency, we would argue that the case for employing PPPs is stronger than ever.

5. Taking full advantage of PPPs

Senior officials in Her Majesty's Treasury in the UK have put forward three principal explanations as to why they introduced the Private Finance Initiative, which is broadly equivalent to Australia's public private partnerships model. The available evidence suggests that PPPs have been highly effective in delivering these outcomes and we would suggest that if the Australian government hopes to take full advantage of PPPs as a procurement tool, then it will be important that these underlying objectives are understood and that policies and processes are designed and implemented so that those outcomes are delivered.

(i) Managing optimism bias – In Australia and the UK, PPPs have been extremely successful in ensuring that projects are delivered on-time and on-budget.ⁱⁱ This is one of the principal reasons why they were first introduced by the NSW government in the late 1980s and by the UK Treasury in the mid-1990s. The Prime Minister has recently spoken of the need for a 'tough, clear-eyed assessment' of infrastructure projects. PPPs have been essential to this because of the transfer of risk, a discipline that it is difficult to replicate within traditional procurement approaches.

However, it is also possible for government to induce optimism bias on the part of bidders, resulting in contracts that are unsustainable. Among other things, this requires government to understand and avoid the kinds of procurement conditions that generate 'bid fever', such as basing the final competition exclusively around price and risk transfer.

Government should seek to understand the reasons why PPPs are successful in managing optimism bias, and build the lessons into future policies and procedures. At the same time, it should design its procurement processes so that it does not shift the problem of optimism bias to the private sector.

(ii) Introducing whole-of-life costing and management – Treasuries have made numerous attempts over the years to introduce whole-of-life costing for public infrastructure, with limited success. While the final results will not be available for some time, the available evidence from Australia and the UK suggests that PPPs have been extremely successful in causing providers to take a long-term view of these projects. Some of the public confusion around the relative cost of PPP projects arises from the failure to recognise that they include the total costs of managing these facilities throughout their lifetime.

However, as noted below, if the ongoing service provider is not a leading member of the PPP consortium, or if they do not have a strong contractual relationship with the owners and financiers of the facility, then it will be less likely that the ongoing operating and maintenance costs will be taken into account in the inevitable compromises that will be made during design, costing and construction.

(iii) Improving risk allocation – PPPs have also opened up a debate about the appropriate allocation of risk in major infrastructure projects, and while much has been learned, we are probably still in the early stages of this debate.

There is still a temptation in some PPP procurements, to maximise rather than optimise risk transfer. In some cases, this can result in the private sector taking on risks that they cannot manage, which is not in government's long-term interests. Even where this does not occur, the debate can result in unnecessary cost and delay in PPP procurement.

6. Capturing productivity gains

It is to be noted that the pursuit of financial savings was not one of the original objectives of the UK Treasury when it established the Private Finance Initiative, and it has proved difficult to compare the relative costs provision under traditional and PPP procurements (for practical and methodological reasons). In the current economic environment, value-for-money is likely to have greater significance in decisions to proceed with PPPs as a procurement route.

There is some evidence to indicate that PPPs can result in significant savings in both construction and operating costs as a result of using this particular form of competition and contracting.

PPPs in the UK prison sector: Prior to the introduction of PPPs into the UK custodial sector, four prisons constructed by the public sector were contracted to private firms. Over a period of four years in the late 1990s, the Home Office assessed each of these prisons against its own public sector comparators, concluding that the contract prisons were, on average, 11–15 per cent less costly than their public sector benchmarks. However, it is likely that this underestimated the cost differential significantly, since the studies failed to take into account public sector pension costs and the taxes paid by prison management companies.

In 1995, when the Home Office decided to contract for a new generation of prisons under the Private Finance Initiative, public sector comparators were prepared to estimate the cost of constructing, financing and operating these facilities through traditional means. It was assumed, for the purposes of calculating the public sector comparator, that any new public sector prisons would be designed and constructed in the traditional way, but that they would be managed by private firms under contract – that is, the savings that were evident from the four prisons already under private management were built into the public sector comparator.

On this basis, the present value of the first of the Private Finance Initiative prisons was a further 17 per cent below its public sector comparator, including construction and financing costs as well as operating costs. However, by the time the fifth Private Finance Initiative prison had been negotiated three years later, the cost per place for a prison of comparable size, had fallen by 38 per cent on the original public sector comparator.

Not all of this cost differential can be attributed to operating efficiencies, although since 60–70 per cent of the present value of a Private Finance Initiative prison is attributable to operating costs, it is likely that they played a significant contribution to the additional savings. While it is difficult to estimate what the total financial benefits might have been, it seems reasonable to assume that over a succession of procurements under two different models, competition reduced operating

costs by 30 per cent or more. The quality of service has not suffered, and it is widely recognised that the UK government used prison contracting to drive their ‘decency agenda’.

Prison PPPs in the UK provide an interesting case study, since they have involved the private sector in delivering front-line public services as well as the full range of support services. Given the scale of the financial savings and the associated improvements in service quality in this sector, Infrastructure Australia might consider the UK prison industry as a case study in PPPs involving social infrastructure.ⁱⁱⁱ

Ultimately, to capture productivity gains operations and maintenance must be considered at the same time as design and build.

7. Placing service design at the heart of infrastructure design

One of the recent criticisms in the UK of PPP schools has been the failure in some cases to involve service users (teachers and pupils) adequately in the design of the physical facility.^{iv} This problem arises when service providers are not closely integrated into the process of designing and building the physical facility. The providers of core services and soft and hard Facilities Management should not be looked upon as accessories to be consulted once the facility has already been designed and costed.

In 2007, the Serco Institute interviewed a number of senior company executives who had been involved in the design of successful PPPs in the UK, focusing on hospitals and prisons, with further reference to a defence training establishment. Understandably, these men and women took the view that the physical facilities should be designed and built to facilitate the better delivery of a public service. They explained some of the reasons why placing service design and delivery at the heart of PPPs resulted in better outcomes:

(i) Integrating service provision – There is a significant difference between merely consulting with service providers and building them into the heart of the PPP, so that they are obliged to warrant the outcomes claimed to flow from their preferred solutions. When a service-based design is more difficult than expected to implement, or where costs may be higher in the short-term, construction, financing and hard Facilities Management partners will be less likely to assume those risks, since they do not have the same long-term service perspective. Involving the service provider as a key member of the PPP consortium ensures that both risks and benefits are brought to account.

(ii) Appropriate boundaries – All projects involve compromises, and often the most important trade-offs that have a potential for long term impact on value for money and the quality of service, are to be found in the detail. Inclusion of the service provider as a senior partner makes it more likely that these detailed tradeoffs will be made in the interests of long-term service delivery. When the service provider is involved in the project from the outset, they will have ownership of the design of the facility. Among other things, this means that they are more likely to adopt a ‘can do’ attitude when tackling problems that later emerge, rather than engaging in blame-shifting.

(iii) Service innovation – Where the government customer has given permission for PPP providers to innovate, then the inclusion of the service provider at the heart of the solution will make it much more likely that there is innovation in the underlying services. For example, at the Forth Valley Hospital in Scotland presently under construction, the freedom to innovate in the service offering, in this case involving hard and soft support services, resulted in the introduction of robots for moving meals, medicines and linen, the first time that they will be used in a British hospital.^v

8. Encouraging innovation

Building on this last point, we would emphasise the potential that PPPs offer to increase the amount of innovation in the design and construction of public facilities and in the design and delivery of public services. Monopolies (public or private) are not inclined to engage in the experimentation and assume the risks associated with innovation. Above all else, it is competition – professional or commercial – that stimulates real innovation and the dissemination of best practice once it has been identified.

The early history of prison contracting in the UK provides an interesting case study in this effect. In that case, public officials had introduced best practice in prison design from the United States of America but they were finding it extremely difficult to import innovative new management practices that were required to accompany it. Competition and contracting became the instrument through which those innovations were imported and adopted to local conditions – leading to major developments in what the UK government has since called its ‘decency agenda’.

Forth Valley hospital (see section 6) provides an example of the benefits of integrating innovations in services and construction. Another simple example can be found in HMP Ashfield, a young offender institution in England managed by Serco as a PPP. In that case, the consortium decided to invest in an all-weather pitch for sports activity that was not part of the original design. It was decided that the pitch would pay for itself in better contractual performance, particularly measures based around the conduct of the young men.

9. Buying better outcomes

One of the significant trends of recent years in public service commissioning has been the movement to buying outcomes and high-level outputs rather than just inputs. A simple example are some of the ‘streetscene’ contracts, which Serco has with local authorities in the UK, where part of the reward is based on an independent survey of what local residents feel about the cleanliness of their streets.

The cutting edge of outcome-based performance contracting is to be found in managed health care, offender management and welfare-to-work, where the intention is to develop arrangements and capabilities where the financial risk of delivering specified outcomes or high-level outputs is transferred to the provider.

There is obvious potential for the application of outcome-based contracting to some PPPs, even PPP roads, where there has been debate in the USA about the transfer of the risk associated with environmental outcomes.

However, in order to ensure that commissioners and providers develop the capabilities required in such a market, a significant programme of staged development will be involved. Complex markets of this kind cannot be constructed overnight.

10. Building deeper markets

We would encourage the government to think of PPPs as a market, rather than looking at them as a series of distinct procurements.

(i) Developing a clear pipeline of opportunities – In the UK, several government reviews have discovered the importance that the industry places on transparency and predictability. The real prospect of repeat business will encourage entrants into the Australian market from overseas and from other related sectors. It will encourage both commissioners and providers to make a deeper

investment in capability. And it will encourage private providers to adopt a longer term horizon and lower discount rates and provide them with an incentive to cooperate with government when changes are required.

(ii) Developing nationally consistent policies and procedures – One of the disadvantages that Australia faces as a federation is that the market is fragmented, and seems even more so to companies from overseas jurisdictions with a unitary state. We recognise that significant work is underway to develop a national policy framework in Australia, although it is inevitable that in practice, differences will emerge between the states, if only because of different political conditions.

There is also the potential for the Australian states to go to the market seeking to meet the same infrastructure needs at roughly the same time. In effect, this will create competition among commissioners for scarce resources, and we would argue that there is a need for better coordination between the state governments in this regard.

(iii) Level playing fields – For the most part, the public and private sectors do not compete when it comes to PPPs, however, with the emergence of new business models over time, particularly public-private joint ventures, it is likely that questions of competitive neutrality will arise.

This is another policy area where Australia has a significant lead on some other parts of the world, however, with a significant expansion of PPPs in this country, and an increase in the role of the private sector in service provision, new level playing field issues will arise.

(iv) Incumbency – Contracting for complex public services, particularly where specialised assets are involved, sometimes raises questions of an inherent advantage for the incumbent. In the case of complex public services, the people are often the most valuable asset, and law and policy must make it as easy as possible for people and physical assets to transfer from one provider to another on contract transition (both private to private, as well as public to private).

(v) Path dependence – With long-term contracts, which are typical with asset-based PPPs, there is a danger that government may lock itself into market models that have damaging consequences for the future development of the market. For example, in the UK, the proposed development of ‘polyclinics’ (a new form of GP medical centre) may be delayed in some areas because of the contractual arrangements made under the ‘LIFT’ model of GP clinics, which were more focused on real estate development.

(vi) Capability is a perennial issue in the discussion of PPPs. The development of deeper markets is one of the ways of overcoming some of these challenges, although it also brings with it the demand for new capabilities. We would stress that this is as much of an issue for the private sector as well as the public sector.

11. Conclusion

The public is demanding higher quality and more convenient services; but resources are limited. Raising service standards, whilst reducing costs, means combining innovation with assured delivery, improving efficiency and effectiveness, and managing the complete change process.

Serco is already operating services across Australia helping governments continue to meet the challenges of providing world class services and infrastructure. However, we encourage governments to focus on infrastructure services, rather than just physical infrastructure, think of PPPs as a market, rather than looking at them as a series of distinct procurements and realise the benefits of employing PPPs as part of a much wider public service reform agenda.

ⁱ See <http://www.berr.gov.uk/files/file46965.pdf>

ⁱⁱ A variety of reports have documented their success in this regard. For a recent summary, see John Fitzgerald, 'Estimation Bias in Public Infrastructure Projects and Procurement Selection and Performance', February 2008, http://www.serco.com/Images/Estimation%20Bias%20in%20Public%20Infrastructure%20Projects_tcm3-28484.pdf

ⁱⁱⁱ For the background research see, Gary L. Sturgess et al, 'Competitive Edge' and 'Competitive Edge: The Evidence', London: Serco Institute, 2007, at http://www.serco.com/Images/Competitive_Edge_Final_tcm3-22515.pdf and http://www.serco.com/Images/Competitive%20Edge%20-%20The%20Evidence_tcm3-23367.pdf

^{iv} See, for example, a recent report by the British Council for School Environments at <http://www.teachersupport.info/uploads/1/BCSE-optimised.pdf>

^v See Briony Smith, *Built to Serve: The Benefits of Service-Led PPPs*, London: Serco Institute, 2007, located at http://www.serco.com/Images/Built%20to%20Serve_tcm3-17996.pdf