SOME ISSUES IN CONTRACT MANAGEMENT
IN THE PUBLIC SECTOR

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to

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I. INTRODUCTION

I am pleased to be invited to present at this conference. I would like to take this opportunity to identify and discuss some important and still emerging issues associated with the management and operation of government agencies and businesses at a time of significant transformation of the public sector and the delivery of public services.

As with many other democracies, Australian governments have been focussing increasingly on achieving a better performing public sector and less costly, more tailored or better focussed and higher quality services to citizens. This has not only involved adapting, or adopting, private sector methods and techniques but also direct participation by the private sector in providing public services, even so-called and traditionally regarded core services such as policy advice and determination of entitlements. Such changes are often described as the ‘privatisation’ or ‘commercialisation’ of the public sector.

Particular emphasis has been placed on the advantages of greater competition in the public sector, or at least contestability, within a framework of ‘competitive neutrality’. The following is an interesting observation in that respect with which I suspect many in this audience would agree:

‘Public-private competition is predicated on the notion that it is not the mode of service delivery (public or private) that leads to improved service quality and lower service costs, but rather the presence and degree of competition.’

Put simply, the broad objective of the current Government is to focus the Australian Public Service (APS) on its core activities which are defined as policy development, legislative implementation and contracting and oversight of service delivery.

Privatisation and/or commercialisation of public services is occurring in Australia on a significant scale. Privatisation at the federal level in Australia has involved three principal contexts:

- the opening up to competition of areas previously reserved to government, such as telecommunications;

- contracting out by public sector entities to private sector suppliers of goods and services in areas such as employment services and information technology; and

- the transfer of some A$50 billion in Commonwealth assets or business to private sector owners.

In the time available, I will be covering only some non-legal issues associated with contracting out by public sector entities. That is a recognition of other contributors to this Conference more qualified to speak on legal matters. I would simply observe, as did the recent Audit Review of Government Contracts in Victoria, that legal aspects
have received insufficient attention in many guidelines, policies and processes. Indeed, we know from experience that legal risks may be considerable. There are also other public interest issues in the areas of administrative law, privacy and Freedom of Information as well as Commonwealth Ombudsman investigations. In reality, there is a myriad of complex and more routine matters that could be covered. You will not be surprised if I start by stressing accountability issues. I will then focus on particular insights in relation to outsourcing, contracting issues and contract management that my Office has derived largely through our audits.

You may be aware that the Australian National Audit Office (ANAO) plans to publish a better practice guide on contract administration later this year. The aim of this publication will be to provide guidance to agencies in the administration of their contracts, focusing specifically on contract management and planning for contract succession.

II. PRIVATISATION OF THE PUBLIC SECTOR

A feature of the changing public sector environment has been the outsourcing of functions which, it is judged, the private sector can undertake more efficiently. Three prominent examples at the Federal level are:

- the Defence Department’s Commercial Support Program which was introduced in 1991. This program seeks to make greater use of civilian infrastructure and national resources by contracting out support functions where this was operationally feasible, practicable and cost-effective. The objective of the program is to achieve best value for money in the acquisition of support services for the Department of Defence and to give the private sector an opportunity to participate in the provision of those support services. The program process involves requesting offers from the private sector to perform support services and comparing those offers with the proposal put forward by any in-house option, where such a proposal may be feasible. The option assessed as providing the best value for money is then selected and a contract is negotiated or, if the in-house option is selected, an agreement for the provision of the service is prepared. In 1998, at which time 94 activities had been market-tested under with a total value over $1.5 billion, my Office completed an audit of the program. The program was chosen for audit due to the significant value of activities involved and the relevance to other Government activities which may be subject to market-testing and outsourcing;

- more recently, the Commonwealth has undertaken its most significant outsourcing to date, that of employment services. This outsourcing initiative (now known as the Job Network) involved contracting out some $1.7 billion of services previously provided by the public sector with payment structures and incentives for service providers linked to the placement of job seekers in work. In September 1998, I tabled a report which examined the management of this process. We found that the agency had followed key principles of good project management in implementing the new market arrangements, that each of the project-planning criteria had been met and that risks had been managed in line with good practice. My Office identified a range of good practices implemented
by the agency examples of which are highlighted throughout the report as well as opportunities for improvement. We have recently completed an examination of the agency’s management of these contracts with employment providers. It is estimated that the value of the next round of contracts, which commenced in February 2000 and will run for three years, will be around $3 billion; and

- the decision to outsource information technology (IT) infrastructure and telecommunications services across budget-funded agencies, subject to the outcome of competitive processes to be undertaken within a ‘whole of government’ framework. Through this strategy, the Government aims to achieve effective support of business needs and service delivery requirements as well as substantial economies of scale resulting in budget savings. Agencies were formed into groups to conduct competitive processes to market test outsourcing of significant components of their information technology infrastructure and telecommunications services. A number of contracts have been let with significant savings forecast. The administration of this initiative is being examined by my Office to assess the administration and financial effectiveness of the implementation of the initiative including assessing the effectiveness of the tendering, contracting and monitoring process undertaken to date. We expect to table a report in September/October 2000. The time being taken is a consequence of a myriad of complex issues involving 18 agencies and the necessity of extensive consultations with those agencies as well as specialist advisers.

I have to confess that I was somewhat disappointed at a reported ‘prediction’ by the vice president of a large outsourcing corporation that audit findings of the ANAO on I.T. outsourcing ‘will be mixed because auditors are looking for the worst’. To the contrary, we are actually looking for the best. In accordance with our legislation, we are not addressing the policy issues of outsourcing. Those decisions have been taken by Government. But we have been examining how well outsourcing and contracting have been managed, including within the performance measures that have been set by the Government. As well, we are well aware of, and sympathetic to, the timeframes in which outsourcing benefits are expected to flow in relation to the often up-front, as well as ongoing, costs involved, not least those described as ‘transaction costs’.

A major impetus for the changes we are seeing has been the fundamental questioning of what government does, or should do, allied with a perception of inefficient (costly) and ineffective (lacking client focus) delivery of public services due to its monopoly provision and/or other constraints of public sector administration. Implementation of the reform agenda has involved organisational restructuring, business re-engineering, outsourcing, commercialisation, privatisation and/or the transfer or abandonment of functions and services. The following advice is apposite:

*The most effective approach to assessing outsourcing uses the governance structure of an enterprise to pinpoint IT functions that could be accomplished effectively by external services providers.*

Outsourcing advocates point to the opportunities offered in terms of increased flexibility in service delivery; greater focus on outputs and outcomes rather than inputs; freeing public sector management to focus on higher priorities; encouraging
suppliers to provide innovative solutions; and cost savings in providing services. However, outsourcing also brings risks to an organisation which cannot be ignored.

The experience of my Office has been that a poorly managed outsourcing approach can result in higher costs, wasted resources, impaired performance and considerable public concern. For example, the Job Network referred to above provides a good example of the inherent difficulties in applying a purely commercial model to the contracting out of community services. With media reports suggesting a number of the original 321 service providers were experiencing financial difficulties, pressure was placed on the Government for additional funding and changes in the commercial relationship. This situation emphasises the need to recognise the complex set of objectives and stakeholder views which must be taken into account when we make decisions in the public sector—such as whether sufficient consideration was given to the impact of a service provider’s closure on unemployed clients.

The main message from this experience is that savings and other benefits do not flow automatically from outsourcing. Indeed, that process, like any other element of the business function, must be well managed and analysed within an overall business case which includes an assessment of its effect on other elements of the business. The latter can be positive or negative. One case in point was the Department of Finance and Administration’s (DoFA’s) outsourcing of all of its human resource management functions. This was assessed as positive for its core business and the arrangement recently won a worldwide outsourcing achievement award.

**Maintaining accountability in an outsourced environment**

The growth of outsourcing, and other new ways of delivering public services, do not obviate or limit the need for accountability to stakeholders. Less direct relationships through the introduction of a new player in the accountability chain—the private sector service provider—and greater decision-making flexibility strengthen that need. There have been a significant number of reviews in Australian jurisdictions concerning accountability issues relating to government contracting.

The recent and continuing adoption, or adaptation, of private sector approaches, methods and techniques in public service delivery has highlighted issues involving gains and losses between the nature and level of accountability on the one hand and private sector cost efficiency on the other. On this issue, it has been noted by Professor Richard Mulgan of the Australian National University (ANU), who has contributed significantly to the debate over public sector accountability within a climate of significant reform, that:

> Contracting out inevitably involves some reduction in accountability through the removal of direct departmental and Ministerial control over the day-to-day actions of contractors and their staff. Indeed, the removal of such control is essential to the rationale for contracting out because the main increases in efficiency come from the greater freedom allowed to contracting providers. Accountability is also likely to be reduced through the reduced availability of citizen redress. At the same time, accountability may on occasion be increased through improved departmental and Ministerial control following from greater clarification.
of objectives and specification of standards. Providers may also become more responsive to public needs through the forces of market competition. Potential losses (and gains) in accountability need to be balanced against potential efficiency gains in each case.13

Optimising the trade-off between accountability and a lower market-oriented price requires senior public service managers to ensure they are not risking the efficiency and effectiveness of their core functions by ill considered, *ad hoc*, outsourcing, the effects of which may not be confined to the particular services or activities being outsourced. To do this, *ex-ante* strategic examination of which activities should continue to be provided by the public sector (core business) and which to outsource (non-core business) is essential. This is consistent with the generally held view in the public and private sectors that outsourcing is a cost-effective way to make better strategic use of non-core business functions.14

Where the decision is made to outsource, value for money should be the primary factor which agencies should be considering.15 This requires a range of factors to be taken into account—not only costs.

To maximise overall value for money, it is important that the above assessment take place in the context of the total business of the organisation in order to manage the risk that, by considering outsourcing individual activities in isolation, counter-productive and costly outcomes may result from outsourcing in the medium to longer term. In this respect, attention should also be given to the effect of outsourcing on related activities which may be delivered through another public sector agency. That is, it might sometimes be necessary to examine an outsourcing decision from an across-agency perspective to get the best public sector outcome.

**Preservation of corporate memory**

In addition to the immediate impact of outsourcing on public accountability, the transition to an outsourcing arrangement can have long-term impacts. There is a particular risk that incumbency advantages may reduce the level of competition for later contracts as a result of the existing supplier having greater information and knowledge about the task than either the Commonwealth agency or potential alternative service providers. This risk becomes more pervasive when the outsourced activity has a significant impact on core business, or competition in the market is limited.

This is an issue that is going to require increasing attention by public sector managers, as has been recognised by the Australian Parliament’s Joint Standing Committee on Foreign Affairs and Trade in relation to the Defence’s Commercial Support Program:

> Frequently, the successful tenderer for the support contract relies on recruiting the trained Defence personnel who have been made redundant in the [Australian Defence Force] ADF because of the function’s transfer to the commercial sector. Through employing these already-trained personnel, the successful civilian tenderer is able to provide a commercially attractive initial price for a support capability because there is no need to factor in staff training costs in the contract. This process
becomes disadvantageous to Defence where the successful tenderer becomes the monopoly supplier of the support service, and Defence must subsequently renegotiate that contract from a position of weakness, having eliminated its own in-house capability to perform the particular function.\textsuperscript{16}

**Ensuring performance/results**

Although the public sector may outsource service delivery, this does not equate to outsourcing the responsibility for the delivery of the service or program. It is the responsibility of the agency and agency management to ensure that the government’s objectives are delivered in a cost-effective manner. The agency must therefore specify in the contract or service level agreement the necessary level of service delivery and required quantitative and qualitative service standards and measures. It must also ensure that an adequate level of monitoring of service delivery under the contract is undertaken as part of the agency’s contract administration. This should also be in line with its broader service delivery responsibilities, such as might be set out in a Client Service Charter.

A recent KPMG survey of private and public organisations in Australia and New Zealand involved in more than $500 million a year of outsourcing contracts indicated that:

\textit{... Performance problems were overshadowed by customers’ own failure to properly define outsourcing goals and service level agreements.}\textsuperscript{17}

More than half the survey respondents indicated they would pay more attention to defining and monitoring service level agreements in the future. Customer satisfaction benchmarking analysis can assist managers in this regard. The inclusion of access provisions within the contract for performance and financial auditing, as well as for sound management, is also very important in maintaining the necessary thread of accountability. I will say more on this aspect later. As Arthur Levitt, Chairman of the United States Securities and Exchange Commission, has observed:

\textit{‘Disclosure enables us to keep our hands off, but our eyes open.’}\textsuperscript{18}

Such findings have also been revealed in the ANAO’s audit work. For example, the audit of the $5 billion (now reportedly over $6 billion) project for six new submarines found that, although only two submarines had been provisionally accepted by the Navy, the agency had paid over 95 per cent of the construction contract funds. This was compounded by the finding that the contract only provides modest recourse by the Commonwealth by way of financial guarantees and liquidated damages for late delivery and under-performance.\textsuperscript{19} The latter also illustrates an often quoted criticism that government contracts generally contain penalties for poor performance but rarely include incentives and/or rewards for high level performance. More even-handed treatment in the latter regard would enhance contractual relationships in areas where ‘real’ partnerships, depending on confident and robust relationships, are necessary to achieve required outputs and outcomes.
Adherence to public service values

Public sector commentators would contend that it is the nature and extent of accountability which distinguishes the public from the private sector. This is reflected in the following observation:

*Ethical behaviour is one of the principal means by which accountability is maintained in the public sector. Indeed, political and administrative accountability depend on the observance of ethical standards and ethical relations between individuals or between institutions.*

The public sector operates, first and foremost, in a political climate which is values-oriented as witnessed by constant references to the ‘public interest’. This concept has always been difficult to define or measure in any generally agreed fashion—except that it is very real to the Parliament and public servants as well as to the ordinary citizen. In short, everyone seems to know when they do not have it. Our public service values are contained in the *Public Service Act 1999* (Section 10). As well, a code of conduct, based on these values, is contained in Section 13, with provisions to deal with breaches in Section 15.

Public servants, at least, must understand the pervasive and often decisive influence of ‘politics’, as opposed to ‘markets’, both on public policy and administration. It means that public sector agencies must balance complex political, social and economic objectives, which subject them to a different set of external constraints and influences than those experienced in the private sector. Consequently, there is an issue of trade-offs between the nature and level of accountability and private sector cost efficiency, particularly in the delivery of public services and in the accountability regime itself. This is a reality we as public servants, meaning all who are employed in the public sector, should never ignore. However, decisions about such trade-offs are basically ones for the Parliament and/or Government to make thus providing guidance to decision-makers, whether in the public or private sector, and not leaving it to the latter by default.

III. SOME CONTRACTING ISSUES

It is important to recognise that managing an outsourcing contract starts before any decision has been taken on the selection process, let alone about the service provider. For this reason, proper project planning is essential to a successful outsourcing partnership. Indeed, a previous Australian Government Solicitor observed that:

*There is often an inverse relationship between the amount of time spent in preparing tender and contract conditions and the resources required to deal with problems in contract administration and disputes after the contract has been formed.*

There is a wide body of administrative case law and procedural guidance applying to government procurement at the Federal level. For example, in relation to the latter, the following are indicative:
More recently, the ANAO published a better practice guide, *Selecting Suppliers: Managing the risk*, that expanded on the above publications and provided detailed guidance and checklists to assist in assessing and managing the risks associated with selecting suppliers prior to awarding the contract. As well, the New South Wales Audit Office recently published a *Contracting Out Review Guide* that contains a checklist of points to consider when drafting a contract. As a relatively recent article from the *Canberra Bulletin of Public Administration* noted:

> Time and again agencies surrender negotiating power in the belief that the “bottom line” has been achieved once a price has been received and accepted. The small matter of finalising the contract is often dismissed as an afterthought seen as a matter of dreary detail. Unfortunately, these “details” which are often negotiated after other disappointed tenderers have packed up and gone home often prove crucial.

One important point to note is ensuring that a contract is actually put in place at the appropriate time—a key legal risk in competitive tendering and contracting is the imposition of a *de facto* contract by the courts where there is no formal document established. As the Victorian Audit Review of Government Contracts stated:

> The law has had to adapt to what people actually do... it is quite possible for parties to ‘drift’ into a contract because of what they have said or done, without there being a formal signing or some other obvious indicator of precisely when the legal relationship started.

A similar outcome related to fees paid in connexion with a share issue to Telstra employees as part of the initial public share offering in that corporation which was covered by an audit in 1998. You may be interested in the particular audit finding and related advising by the Office of the Australian Government Solicitor.

The current framework embodies important principles such as value for money, open and effective competition, ethics and fair dealing, and accountability. The salient point is that the level of procedures required in the selection process should be in direct proportion to the nature, extent and complexity of the products and/or services to be provided. One size does not fit all. Some of the other specific issues facing APS agencies are explored further below.

**Selecting the appropriate contractual relationship**

Application of the most appropriate contractual relationship can deliver significant performance improvement and savings in the underlying costs of contract administration. Some organisations in the private and public sector have
demonstrated the benefits of taking a fresh look at contractual relationships to achieve the most efficient and effective method of service delivery.

Following the strategic decision to use an external service provider, there is a number of choices to be made, particularly relating to the best approach to manage the contract relationship. The contract relationship adopted depends on the organisation’s business objectives, internal constraints and the willingness of staff to try alternative approaches.

Provision of services and projects using contracted services involves many people. Efficient coordination of each of their time and skills is often a complex undertaking. The choice of an effective contractual relationship is crucial to establishing a good working relationship between the contracting parties and ultimately to a successful outcome.

Contracting relationships can be categorised into the following groups:

- **traditional** relationships—legalistic frameworks create a strong compliance/control relationship relying on extensive checking and verifying of the contract against the service delivery and a tendency towards an 'adversarial' culture. This relationship centres on the obligations set out in the contract and tends to be at arm’s length with each party seeking maximum advantage;

- **cooperative** relationships—involves both the purchaser and provider, to varying degrees, in cooperative management of the contract. This approach incorporates ideals such as developing trust, obtaining commitment and improving communication;

- **partnering** relationships—formalised processes underpinned by both a moral and legal agreement binding key stakeholders and other parties to act in the best interests of each other. The basis of partnering is: together we can solve problems and maximise opportunities. Partnering relies on commitment by parties beyond the terms of the contract. It also involves parties outside the contract—key stakeholders can be involved in relevant aspects of overall contract management; and

- **alliance** relationships—take the key elements of partnering to the next step by having a risk/reward sharing philosophy as well as a transparent or open-book approach towards all financial matters, including cost and profit. Alliance agreements can be more effective than other arrangements for providing services that are difficult to define, are critical to an organisation’s performance and require innovative solutions from the provider and creative management by the purchaser. They are also beneficial in long-term, strategic contracts as each party relies absolutely on the performance of the other.

Recently, my Office tabled a report\(^\text{32}\) that examined the Commonwealth’s first project alliancing arrangement—for the establishment of new facilities for the National Museum of Australia and Australian Institute of Aboriginal and Torres Strait Islander Studies. Not only is the project delivery strategy the first of its kind for the Commonwealth but, according to the Department of Communications, Information
Technology and the Arts, project alliancing has not previously been used on a building construction project anywhere else in the world. The report found that the project alliancing arrangements used complied substantially with the *Commonwealth Procurement Guidelines* including, importantly, its value for money principle.

**Private financing of government activities**

In the current budgetary environment, public sector entities in many countries have often found it difficult to provide dedicated funding for large projects out of annual budgets, thus resulting in lengthy delays before projects can proceed, or projects proceeding only incrementally over a number of years. Delayed access to needed infrastructure can be costly to the community while budget constraints can lead to sub-optimal project outcomes. The encouragement of private sector investment in public infrastructure by governments is one response to these fiscal pressures. It has also given rise to additional challenges and demands for public accountability and transparency because the parameters of risk are far different from those involved in traditional approaches to funding public infrastructure. Indeed, the potential liabilities accruing to governments may be significant.

Extensive use has been made of private financing in the United Kingdom (UK). The Private Finance Initiative (PFI) was introduced in 1992 to harness private sector management and expertise in the delivery of public services. By December 1999, agreements for more than 250 PFI projects had been signed by central and local government for procurement of services across a wide range of sectors, including roads, rail, hospitals, prisons, office accommodation and IT systems. However, one downside was the frequently protracted negotiations which resulted in substantial legal costs to both sides. Another downside was the need to consider the flexibility necessary to deal with changing developments in service delivery and citizens’ demands in long-term contracts with major financial commitments.

The UK National Audit Office (NAO) has noted that the private finance approach brings with it new risks to value for money and requires new skills on the part of the public sector. Since 1997, the NAO has published eight reports on such projects. These reports collectively suggest that for privately financed projects to represent value for money, the price must be in line with the market, the contract must provide a suitable framework for delivering the service or goods specified and the cost of the privately financed option (taking into account risk) should be no more than that of a publicly funded alternative.

In particular, the NAO advocates an approach involving the ‘optimum’ transfer of risk, as follows:

> *If the private sector are asked to accept responsibility for a risk that is within their control, they will be able to charge a price for this part of the deal which is economically appropriate. However, if the Department seeks to transfer a risk which the private sector cannot manage, then the private sector will seek to charge a premium for accepting such a risk, thereby reducing value for money. The Department should therefore have sought to achieve not the maximum but rather the optimum transfer of risk, which allocated individual risks to those best placed to manage them.*

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A particularly interesting example of risk sharing is that between British Telecom and the UK Ministry of Defence in the ‘Defence Fixed Telecommunications System’. A report commissioned by the UK Treasury indicated that, for 17 PFI projects for which sufficient data were available, risk transfer valuations accounted for about 60 per cent of the total cost savings forecast for those projects. That report also noted the clear linkages between risk transfer and private sector management skills and some potential for double counting of savings.

In Australia, most of the activity in private financing initiatives has occurred at the State government level, particularly in relation to infrastructure projects such as roads. Prominent examples include Sydney’s Harbour Tunnel and M2 Motorway and Melbourne’s City Link project. Of note is that these high profile projects have been the subject of external scrutiny that has raised concerns about the exact distribution of risk and financial benefits between the public and private sectors, for example:

- the New South Wales (NSW) Auditor–General has consistently commented that, although private sector owners have been given long-term rights over important road networks, there has not been a proper comparison of the cost-effectiveness of private sector involvement and the traditional public sector approach. Accordingly, the Auditor–General was unable to conclude that the projects that have been undertaken were in the State’s best interests from a financial viewpoint. In particular, the opportunistic and ad hoc use of private finance was criticised as it was considered unlikely to improve the overall efficient use of the road network and reduce the total costs of road maintenance and management;

- the Melbourne City Link project is one of the largest infrastructure projects ever undertaken in Australia with an estimated total cost of around $2 billion. It involves around 22 kilometres of road, tunnel and bridge works linking three of the Melbourne’s most important freeways. A report by the State Auditor–General found that, while the users of the City Link via toll payments will, in substance, be the financiers of the project, the private sector has accepted substantial obligations associated with its delivery and operation, including traffic and revenue risks. However, the auditors also found that the decision to establish the City Link as a toll road was not supported by a financial model which compared project costings on the basis of private sector financing versus government borrowings.

At the national level, the 1996 National Commission of Audit observed that the private sector has a significant capacity for a greater role in infrastructure services. The Commission also concluded that the role for government could be reduced and suggested that the identification of good opportunities for private sector investment in infrastructure could assist the goal of increased national saving. Accordingly, there has been increasing interest in private financing initiatives in Australia at the federal level, although to date there has been limited actual adoption.

One example where PFI has been adopted involves the agency responsible for funding and managing the development of Australian government office and diplomatic properties. That agency adopted private financing for a number of projects but has since discontinued private financing arrangements. My Office recently examined one
of these projects, within the context of risk management on foreign exchange dealings. The key message here is the need for public sector managers to fully appreciate the nature of the commercial arrangements and attendant risks involved in private financing initiatives.

The Department of Defence also is considering the use of private financing to realise financial savings or improve effectiveness in the delivery of Defence services, including capital equipment as well as Defence facilities, logistical support and information technology programs. The clear intention on the part of Defence in widening the use of private financing is to achieve the best affordable operational capability. Of course, any such move towards private financing of Defence activities would need to consider what core business the Department needs to maintain in order to manage effectively the longer-term risks that are involved in any outsourcing. With this in mind, the Department has recently indicated the following views:

- **Opportunities for Private Financing of Defence projects will be assessed on a case by case basis to take account of military command and control requirements and Defence and international policy implications.**

- **Private Financing is commonplace in civilian infrastructure projects and has been used successfully by the UK Ministry of Defence.**

- **Regarding Australian vulnerability through foreign ownership and control of Defence equipment, access and control are the important features, not ownership, and these are addressed in Defence’s framework for selecting and managing Private Financing projects. Any arrangements that jeopardise the assurance of control of Defence capability will not be pursued.**

A Defence Discussion Paper identified a number of lessons drawn from case studies arising from the UK Ministry of Defence’s experience as well as that of two State Governments—these may be of interest to other public servants, who are required to deal with similar private financing issues, albeit involving different subject matter.

In view of the growing interest in and use of private financing initiatives and the important financial, risk transfer and accountability issues raised, it can be expected that Auditors-General will increasingly focus their attention on examining such activities. It is hoped that such scrutiny can assist in optimising outcomes and providing assurance to the public and Parliaments about the processes adopted and outcomes achieved. In this context, I commend the work done by the NAO in examining privately financed projects and in providing sound guidance to auditors on how to examine value for money of privately financed deals. This is a useful basis on which to move to a discussion of a more networked approach to public administration not only with the private sector to achieve better accountability and efficiency but also within the public sector itself.
Moving to a more networked approach

In an increasingly global environment, the question of competitiveness and/or contestability of the public sector against similar elements in the private sector would seem to be likely to focus greater attention on the need to be more outwardly than inwardly focused in the future at least. External pressures may require the development of ‘real’ partnerships between the public and private sectors in the interests of maintaining national sovereignty and global competitiveness. The imperative would then be to develop a highly performing public sector to complement the private sector rather than just compete with it. In this respect, it is interesting to consider the UK ‘Modernising Government’ approach which stresses ‘partnership delivery’ by all parts of government as well as with the private sector. The NAO subsequently reported on its response (and strategies) to that policy, including the notion of ‘joined-up’ government.

In a similar context, an academic paper published in 1999 noted the emerging image of ‘network bureaucracy’ stressing co-production of results as against ‘market bureaucracy’ with its emphasis on contracting-in and introduction of quasi-markets. The move to an output/outcomes framework for managing resources and measuring performance at the Federal Government level has engendered discussion about ‘shared outcomes’ and the strategic and other relationships between outputs that contribute to those outcomes and those organisations responsible for both. The UK approach notes that:

‘... when boundaries become barriers to the free flow of information, ideas and creative energy, they risk creating rigid, inefficient organisations. That is true of both internal and external boundaries.’

Nevertheless, while recognising there are debates, for example, about transactions costs issues associated with contracts and markets, academic writers have also pointed out the limitations of trust-based relationships, longer-term instability of inter-organisational networks, unintended consequences such as fraud and corruption and resistance to innovation and protection for under-performing organisations. This point has been expressed more pragmatically, recognising that the informality of a network may raise concerns about lack of clear (definable) accountability, as follows:

Managers in public services who have had experience of marketization, competitive tendering arrangements and a contract culture may even express some dismay at the thought of having to operate within the context of a loosely coordinated and informal network of providers.

There was an interesting article in a recent edition of the International Journal of Public Sector Management which discussed the notion of trust-based relationships. These relationships are illustrated in a self-explanatory manner in Attachments A and B. The latter attachment highlights the importance of the general public as a party to the interactions in public sector contracts.
The UK Modernising Government approach recognises the issue and observes that:

‘Cross-cutting working involves more complex accountability arrangements than traditional arrangements and may involve more risk. But it can also yield significant benefits.’

The theoretical framework of the market bureaucracy, sometimes referred to as ‘entrepreneurial governance’ or ‘contractualism’, represents the current prevalent type of public organisation management, in which the internal elements of such agencies are structured around markets, and real or hypothetical tests of consumer demand. Market-type bureaucracies in Australia have taken shape in the rapid increase in recent years of the use of contracting in and between organisations, combined with the proliferation of a range of ‘quasi-markets’ for certain public service provisions as health, welfare and educational services.

There are many examples of recent APS initiatives that can be regarded as indicative of market bureaucracy at work in public organisations. My earlier discussion of the Department of Defence’s Commercial Support Program provides a clear example of a large-scale market bureaucracy where service provision is dominated by competitive tendering and contracting. What is not certain, however, is that the market form of organisation is effective in developing new systems of quality service delivery and creating functional institutional linkages within policy sectors. As such, there are several potential problems that can result through market bureaucracies.

First, there is scope for increased distortion and goal displacement through the declining use of internal rules and an increase in entrepreneurial behaviour by bureaucrats. There is also the potential for the corruption of central policy goals by contractors seeking to maximise short-term profits and other immediate material payoffs. For example, the extensive use of contracted service providers in some public sector agencies can have important implications for the agency’s ability to maintain its surge capacity in times of high demand, as the need for high level of service provision may be incongruent with the contractors’ profit motive. Again, Defence is one agency in particular where there is a need to ensure that the overall impact of support service outsourcing does not adversely affect core business and does not erode core capability by default.

Financial and performance risks associated with market bureaucracies have also become apparent in Australia as part of the outsourcing of employment services previously provided by the public sector that I mentioned earlier. Under the outsourced arrangements, payment structures and incentives for service providers are linked to the placement of job seekers in work. The publicly owned provider fared poorly in the most recent round of tender, losing most of its contracted work to provide intensive assistance services, which are considered to be the most lucrative for service providers. However, there was public concern that the loss of these contracts could render the public service provider not financially viable and that it may not be financially viable for commercial entities to provide employment services in some areas, particular rural and regional areas. The Government has committed to fund the public service provider for three years in order to ensure rural and regional access to employment services.
The weaknesses in market-based bureaucracies have seen renewed interest in the concept of network bureaucracies. In comparison, the network bureaucracy concept proposes interdependence as a binding characteristic where services are tailored to individual or small batch clients and costs are shared across an inter-organisational web of co-producers. Network agents are the local officials who take direct responsibility for establishing effective links between suppliers, co-producers and customers. Joint strategic planning and management are essential for successful networking. It has been suggested that:

‘... the move towards network arrangements could well produce better outcomes for the public if there is one organisation at the centre of each network providing influential leadership.'

There do appear to be indications that the network bureaucracy concept is gaining favour in Australia in particular areas as a means of delivering more responsive public services to citizens. For example, one recent ANAO report discussed how three welfare agencies were defining their particular outcomes and outputs and how the outputs of one of these agencies were directly related to the outcomes of the purchasing departments. These arrangements have subsequently expanded such that the particular Commonwealth agency, Centrelink, now delivers services on behalf of a total of four agencies under formal purchaser-provider arrangements.

More networked approaches to service delivery envisage more sophisticated and cooperative approaches to cross cutting issues and stress the importance of partnerships, coordination and joint working. This is increasingly occurring at the inter-agency level and networking can be expected to evolve to include strategic arrangements and structures (including for shared and specific accountability obligations) between public organisations, private operators and voluntary associations as well as individual clients and the community generally. Such interaction should in turn generate new forms of service delivery and redefine the relationship between government and the community.

More networked or partnered arrangements can also overcome some of the inflexibilities of a contract. Partnering and strategic alliancing are increasingly being adopted in the private sector as a means of coordinating economic activity. Such networked arrangements are seen to enable a greater exchange of ideas and information and allow partners to gain access to knowledge and resources of the other parties. The Victorian Public Accounts and Estimates Committee observed that a partnering approach could be warranted where:

- service providers are encouraged to be innovative in the delivery of services;
- the nature of the services is highly variable or evolving, leading to poor predictability of demand and service content; and
- the services will be using leading edge practices/technology in which a high degree of flexibility on the part of both parties will be required to make it work.
Another important aspect of developing networked solutions is the availability of information to clients. Information technology is providing significant opportunities for government to ensure that existing and potential clients have access to the information they require. Information technology can also be an effective tool for improving the cost-effectiveness and quality of services provided to citizens. It is also central to improving accountability. It is not an exaggeration to suggest that the effective networking of information technology systems will be crucial to implementing integrated public services and their responsive delivery in a seamless manner to citizens. This is also a central consideration for the knowledge management function, particularly in the contracting out of IT support services as well as telecommunications – based public inquiry services.66

**Costing of services**

Before deciding to contract out it is important to assess the overall cost before and after outsourcing and the expected outcomes from using the contract. This is essential in determining ‘value for money’ as the ongoing central element of procurement policy. The overall cost must include any one-off costs and the continuing transaction costs, such as the cost of administering the contract. The latter may involve cost assessment in terms of net present values which raise the issue of the appropriate discount rate to use. Experience suggests that full costing of this nature is often not undertaken. It has also been commented that:

> Consideration of public policy and public interest tend to be marginalised by commercial and competitive considerations.67

In the same vein, the then Commonwealth Ombudsman remarked that:

> In the public sector the imperative of reducing costs has not translated itself into cost competitiveness or better services. Rather it has resulted in various ways to ration services.68

The apparent inflexibility of contracting, in the sense of being a relatively fixed set of terms, is one intangible cost that needs to be taking into account before deciding to contract out. As well, the move from traditional public administration to contract increases legal risk, that is, the risk of litigation and associated financial penalties such as damages which are not generally exacted under public law remedies. While there are measures, which can be taken to overcome these issues, they add to transaction costs. Failure to take into account the full overall cost can undermine the very purpose of contracting which is to increase the efficiency and cost effectiveness of public administration.

**Testing the market**

The overall objective of market testing is to achieve the best value for money in the purchase and/or delivery of selected services in agencies and to give the private sector an opportunity to participate in the provision of those services. It is important to recognise that an evaluation of current APS delivery practices can be part of the market testing exercise.
I referred earlier to an ANAO examination of the Department of Defence’s Commercial Support Program (CSP) which showed that 94 activities had been market-tested under CSP with a total value of over $1.5 billion. Fundamental to the CSP was the system of in-house bids where internal staff are given the opportunity to bid against the market for provision of their services. Thirty per cent of these were won by in-house bids.

A number of recommendations were made in that audit regarding better practice contract management drawn from overseas (United States) examples. These included how in-house bids were managed (that is, actively encouraging strong in-house bids which may require reengineering of in-house functions), the use of incentive clauses and short term contracts with a number of options to renew to help drive the behaviour of the provider to meets its performance targets.

**People management**

From the perspective of APS agencies, there are change management issues involved with the decision to outsource. The process should be managed so that staff are clear as to:

- the reason for the decision to outsource;
- the intended outcomes;
- the process that will be worked through to achieve the specified outcomes; and
- the impact on individual staff members.

The ANAO has prepared a better practice guide (BPG) on *Managing APS Staff Reductions* which provides guidance to agencies in successfully managing the impact on staff of such management decisions. This BPG was produced following audit observations and a recommendation by the Government that suggested that such guidance would be of timely assistance to agencies in their management of staff restructuring. Unfortunately, this is an area where the public service still has scope for considerable improvement and which, as is indicated in many private sector studies, has a marked influence on staff loyalty, productivity and responsiveness.

One of the issues which will no doubt be discussed in this Conference is the legal decision concerning the application of public sector conditions of service to employees doing substantially the same type of work in an outsourced situation, even if they had not previously been employed in the public sector.

**The importance of managing risk**

Effective risk management should underpin all aspects of contracting, that is, the seven identified steps in the contract management lifecycle:

- specifying the activity;
- selecting the acquisition strategy;
- developing and releasing the tender documentation;
• evaluating the tender bids;
• decision and implementation;
• ongoing management; and
• evaluation and succession planning.

In particular, there are certain phases of the tendering process which are high risk and need to be managed systematically. Some of those are identified in the recent Victorian Audit Review quoted earlier.\textsuperscript{74}

The risk management process generally used in Australia today\textsuperscript{75} is modelled on the Australian/New Zealand Standard AS/NZS 4360:1999 \textit{Risk Management}. A comprehensive approach to risk management will therefore consider risk treatments both proactively—designing and implementing controls to prevent the risk events occurring, and reactively—to mitigate the consequences should the risk event(s) actually occur.

When any risk event becomes a reality, the primary objective is to have treatments in place to mitigate the business impact of the event. In the case of contract administration risks, this means ensuring the risks associated with substandard contract delivery are identified, analysed, and cost-effective treatments devised to control and monitor those risks. As part of the contract administration process, treatments and monitoring mechanisms should assess both the performance of the contract delivery, and the performance of the risk treatments used by the purchaser organisation.

Several ANAO audits have found that agencies had not based their particular outsourcing arrangements on sound risk management practice. For example, the audits of the Green Corps program\textsuperscript{76} and the Sydney Airport Noise Amelioration program\textsuperscript{77} found that a comprehensive risk assessment had not been undertaken prior to the commencement of the contracts in question. As well, the audit of Migrant Settlement Services\textsuperscript{78} found that there had not been a systematic approach to managing risk over the life of the contract.

Other audits have identified areas where particular risks have not been managed effectively. For example, in 1997, the supplier of passenger and commercial vehicles to the majority of Commonwealth bodies (known as the DASFLEET) was finalised for a price of $408 million. Associated with the sale, a five year tied contract was signed for vehicle leasing and fleet management to be provided by the purchaser to the Commonwealth. The audit of the sale\textsuperscript{79} found that the financial implications of the tied contract were such that the Commonwealth was exposed to a range of commercial risks including increased leasing charges and potential responsibility for the cost of terminating the contract. As a result of an audit recommendation, the relevant agency initiated a comprehensive review of the Commonwealth’s financial exposures under the contract.

In the ANAO’s experience, some agencies, faced with the prospect of adverse comment in an audit report about the transparency and accountability of their risk
management or other processes, have argued for an emphasis on the outcomes being achieved by the agency. The following observation made by the then Chairman of the Senate Standing Committee on Finance and Public Administration, reflects the ANAO’s response to such arguments:

[Risk management] does not mean that managers can expect to be judged only on the efficiency and effectiveness of their results and be able to claim that the mix of inputs chosen, how they are applied and the selection of who is to supply them is outside the reviewer’s area of concern. The fundamental principles of accountability have not changed: information still needs to be readily available to allow reviewers to make their own assessments about the legal and proper use of inputs and the ethical behaviour of the people involved in the processes. Managers cannot simply claim that the ends justify the means.\(^{80}\)

Access to information

A significant challenge for Auditors-General in the move to increased contracting with the private sector for the provision of government services is our actual ability to access the relevant records. At present I do not have a legislative provision similar to that which I understand applies in the United States that guarantees access by government auditors to the private sector service providers’ premises.

Instead, my Office encourages the inclusion of a suitable access to premises clause in contracts with the private sector. Such a clause is not necessary to enable me to seek access to information as that access is available under Section 32 of the Auditor-General’s Act 1997. However, it is seen as important to indicate to contractors that they must give full access to the Auditor-General for proper accountability.

While the need for the ANAO to have access to the premises of third party service providers is likely, in practice, to be required in very few situations, the ANAO suggests that such access, where necessary, would contribute to an audit being undertaken in an efficient and cooperative manner. As well, it is important for both management performance and accountability. In the main, audit and management’s interests in access are likely to coincide.

In my view, it is a matter of educating both parties, whether in the public or private sector, to the requirements of a successful relationship or contract and the audit assurance that can go with it. In reality, the latter is an important ‘protection’ for all parties. I noted with some interest the recent positive response by private sector companies to the Victorian Auditor-General’s request to the Victorian Government to give him extra powers to audit the books of private companies involved in outsourcing or other privatised State projects.\(^{81}\) I noted with even more interest the Victorian Premier’s reported comment that it was ‘very likely’ the Government would do so.\(^{82}\)
Commercial-in-confidence information

The subject of non-disclosure of information through commercial confidentiality clauses is linked strongly to the general access issue. Virtually all traditional accountability mechanisms rely on the availability of reliable and timely information. As a result of contracting out to the private sector, the flow of information available to assess performance and satisfy accountability requirements has, on the whole, been reduced. This situation has arisen where performance data is held exclusively by the private sector or through claims of commercial confidentiality that seek to limit or exclude data in agency hands from wider parliamentary scrutiny. Thus accountability can be impaired where outsourcing reduces openness and transparency in public administration. For this reason, the issue of commercial confidentiality is an area that been the subject of considerable parliamentary concern and comment in many constituencies both in Australia and overseas. Furthermore, it is likely to be of increasing importance as the extent and scope of outsourcing grows.

The Australian Senate’s Finance and Public Administration References Committee (F&PA) recently commented:

> The number of contracts entered into on behalf of the government has increased exponentially with outsourcing, with concomitant accountability issues presenting themselves. The committee examined these matters and reported on them in 1998.83

The Committee went on to note, with related references, that:

> There have been a number of inquiries from government instrumentalities, including the Productivity Commission in 199684 and the [Administrative Review Council] ARC in 199885. All Auditors−General continue regularly to comment on the issues. And in the parliamentary arena, the Victorian Public Accounts and Estimates Committee has recently completed a major study86; a New South Wales Legislative Council standing committee examined the employment contract of the Commissioner of Police87; and federally the Joint Committee of Public Accounts and Audit is currently examining contract management, in the wake of such much-publicised contractual problems such as the fire of HMAS Westralia and the Collins class submarines.88

I consider that the question as to whether or not commercial-in-confidence information should be disclosed to the Parliament should start from the general principle that information should be made public unless there is a good reason for it not to be. In other words, there should be, in effect, a reversal of the principle of onus of proof, which would require the party that argues for non-disclosure to substantiate that disclosure would be harmful to its commercial interests. However, I also appreciate that outsourcing agreements have to accommodate the differing interests of public and private law that are brought together in such agreements. This standard has also been supported by F&PA as follows:
The committee agrees [with the ANAO and the Commonwealth Ombudsman] ... where information is withheld on commercial confidentiality grounds, at the very least the reasoning behind the decision should be provided promptly to the committee.

In our experience, we have found that, almost without exception, the relevant issues of principle can be explored in an audit report without the need to disclose the precise information that could be regarded as commercial-in-confidence. In this way, the Parliament can be confident it is informed of the substance of the issues which impact on public administration. It is then up to the Parliament to decide the extent to which it requires additional information for its own purposes. I am also sensitive to the following responsibilities of Auditors–General:

*The first is to ensure that adequate safeguards are in place to protect the confidential information from disclosure. The second is to manage the audit risk that follows from the non-disclosure.*

As a result of a recent motion by Australian Senator Andrew Murray—requesting that agencies post on their web sites lists of contracts entered into, indicating whether they contain confidentiality clauses and, if so, the reason for them—F&PA conducted a short inquiry. As a result of the report from that inquiry, my Office has given an undertaking to conduct a performance audit on the use of confidential contract provisions. Once that audit has been completed, the Committee will report again on Senator Murray’s motion. You may be interested in reviewing the eleven considerations that the Committee asked me to take into account in the course of the audit and report.

The message here is that external scrutiny (through, for example, the activities of parliamentary committees and Auditors–General) is an essential element in ensuring that public accountability is not eroded, by default, through contracting out. Just as it is incumbent upon public sector agencies to ensure they have a sound understanding of the commercial nature of any contract, private sector entities need to recognise that there are overlaying public accountability issues, not present in purely private sector transactions, that need to be addressed. The latter should not unnecessarily deter private sector participation if handled appropriately. There is a balance that has to be struck between the appropriate nature and level of accountability and the imperative to achieve cost-effective outcomes by public sector managers.

Nevertheless, should some degree of confidentiality be considered appropriate in either, or both, the Commonwealth’s or private sector provider’s interests, there is a good case for the Commonwealth, as a matter of course, seeking to include a provision in contracts which provides an exemption with respect to disclosure to a parliamentary committee, if only on a confidential basis. I will leave the last word on this matter to the Senate Committee:

*Additional transparency provisions may be a cost that we have to meet to ensure an acceptable level of accountability.*
IV. CONTRACT MANAGEMENT

Crucial to meeting the challenge is the contract itself and how it is subsequently managed. The purpose of a contract is to make a legally enforceable agreement. Our audits have clearly illustrated the value of written consultancy contracts that reflect the understanding of all parties to the contract, and which constitute the entire agreement between the parties. Otherwise, the documentary trail supporting the authority for the payment of public money and contractual performance requirements, incentives and sanctions may not be clear. It is recognised that contractual performance is maximised by a cooperative, trusting relationship between the parties. However, it should never be forgotten that such relationships are founded on a business relationship in which the parties do not necessarily have common objectives. This aspect will vary with the nature of the contracts concerned to a less or greater degree.

Key responsibilities of contract management include contract administration, monitoring the contractor’s performance and evaluating the contract before its expiry as part of succession planning. In this section, I want to focus particularly on aspects of the first and third responsibilities. I commented earlier on the importance of monitoring contract performance, the second responsibility, which is a topic which could easily be the subject of a separate paper by itself and cannot be done justice here. Relevant comments were also made under the discussion of managing risk. Perhaps the most compelling point on performance information was made by the Senate Finance and Public Administration Legislation Committee as follows:

‘It hopes that others (agencies) will learn from the positive examples and eschew, in future, such performance indicators as ‘outsourcing tender issued’ with the marketing performance measure ‘successful tender selected’.’

The Committee went on to convey its intention to monitor assessments of services delivered by the private sector.

The skills for contract administration

The effective and efficient management of the relationship with the private sector by government agencies requires a solid foundation of commercial, project management and policy skills. There is a particular risk that the private sector service provider may have greater information and knowledge about the task than the Commonwealth agency. If they are not to be disadvantaged by this situation, public service contract managers will need a level of market knowledge and technical skills that are at the same level, or above, those prevailing amongst the private sector service providers.

In this context, public sector managers and auditors need to be cognisant of the potential risks which might arise from project management arrangements with private sector investors, such as:

- short term flexibility may be compromised by unforeseen ‘downstream’ costs or liabilities which erode or offset early gains;
• there may be a tendency for government to bear a disproportionate share of the risks, such as through the offer of guarantees or indemnities;

• the failure of private sector service providers may jeopardise the delivery of the project, with the result that the government may need to assume the costs of completion plus the costs of any legal action for any contractual breaches;

• drafting inadequacies in contracts or heads-of-agreement with partners could expose governments to unexpected risks or limit the discretion of future governments by imposing onerous penalty or default clauses;

• inadequacies in the modelling and projection of costs, risks and returns may, under some conditions, result in an obligation by governments to compensate private sector providers for actual losses or failure to achieve expected earnings;

• there may be some loss of transparency and accountability for disclosure as a result of a private sector provider claiming commercial confidentiality with respect to the terms of their investment; and

• the level of private sector investment and the amount of risk private sector providers are willing to bear may be inversely proportionate to the conditions placed on them by governments to determine pricing, to manage delivery of community service obligations, or to transfer or sell an interest in the project.

During recent years the management of contracts by public sector agencies has been of particular concern to my Office and I have tabled a number of audit reports which address this area:

• one agency selected a service provider and provided advanced funding of 80 per cent of the contract fee to a contractor without undertaking any financial viability checks on the contractor. The contract was negotiated and entered into through a regional office of the agency on referral from the agency’s national office. However, the regional office staff was later found not to have adequate experience to negotiate or manage the contract. The contractor later abandoned the project before it was fully completed because of the withdrawal of its financial backers. As a result the agency terminated the contract and has taken legal action in an endeavour to protect any remaining Commonwealth funds held by the contractor;\(^95\)

• in conducting the initial sale of Telstra shares, advisers were appointed without having regard to the fees quoted by the tenderers because the Commonwealth agency considered the expected outcome in sale proceeds to be more important than sale costs. The contract fees, amounting to some $91 million, are the highest ever paid in a Commonwealth public share offer and were significantly above those indicated by other tenderers. Furthermore, the contractual arrangements required fees to be paid for services that were not provided and other fee payments departed from the terms of the relevant contract, which the agency said did not fully capture the commercial understanding of the parties as to the basis on which fees would be calculated and paid;\(^96\) and
an important part of the 1994 sale of the former Commonwealth Serum Laboratories (now CSL Ltd) was the execution of a ten year contract for A$1 billion between the Federal Government and the soon to be privatised company for the supply of blood plasma products. The audit of the sale process found that systems had not been established to manage the risk of overpayments under this contract. A follow-up audit of the sale audit, focusing on the administration of the long-term contract by the relevant public sector agency was completed in December 1999. The audit found that the management of the long-term supply contract was deficient in relation to the planning and conduct of commercial negotiations over price adjustments and inadequate financial controls over the payment of more than $400 million in public funds for blood products.97

A common theme of these audit reports has been the deficiencies in the project management skills of agency decision-makers, which is of concern given that some of these projects involve substantial resources and complexity.98 As well, reports have flagged a need for care in assessing value for money and negotiating, preparing, administering and amending major contracts. The Parliament and the media have also paid particular attention to these issues during recent years with several agencies receiving significant adverse comments and publicity. I am not alone therefore in stating that this situation has to be addressed as a matter of urgency. The various elements of the public sector that are involved in contract administration have to reverse such concerns to win back the confidence of all stakeholders. Future audit reports will closely examine relevant contracting issues to ascertain better practice in these areas as well as lessons learnt to assist agencies generally in improving their performance.

The concern that I have expressed in such reports has been echoed in a recent report covering the findings of a survey of government contracting officers and private sector contractors to government, conducted by the Institution of Engineers Australia.99 The report’s author, Athol Yates, concluded that government is not always a smart buyer of technology, principally due to a lack of subject matter expertise. The report observed that:

**Being an uninformed buyer puts at risk the ability to:**

- select and justify the option which offers best value for money;
- select and justify an innovative solution;
- reduce contractor risks by providing relevant technical details in tender documents; and
- prevent unscrupulous contractors taking advantage of the buyer’s lack of knowledge.100
F&PA’s second report on Contracting Out of Government Services also makes comment on the need for appropriate contract management skills:

*Despite the volumes of advice on best practice which emphasise the need to approach contracting out cautiously, to invest heavily in all aspects of the process and to prepare carefully for the actual implementation, and the substantial body of comment in reports from the Auditor–General indicating that Commonwealth agencies have a very mixed record as project and contract managers, the prevailing ethos still seems to promote contracting out as a management option that will yield inevitable benefits. Resources must be made available to ensure that contract managers have the skills to carry out the task.*

As well, in a submission to the JCPAA in their current inquiry into Contract Management in the APS, Dr Nick Seddon stated:

*One of the principal difficulties that has faced management in the era of contractualisation of government is that public servants are not trained to be contract managers. Yet, there are many public servants who are doing just that. Over time, no doubt, this deficiency will be rectified, but it is my impression that there is inadequate attention being paid to the lack of skills of public servants who are expected to administer contracts.

...When one considers the... legal risk and the ease with which legal liability can arise, the lack of training of public servants is worrying. It is probably true that this legal risk has generally not translated into litigation (with some exceptions). But what is not known is the extent to which the Commonwealth has had to settle a dispute on unfavourable terms because it is clear that a Commonwealth officer has done something wrong which could have been avoided with proper training.*

The need for project management skills does not need to equate a full time complement of skilled project and contract managers. Rather, agencies should ensure that, if the current decision–makers do not have the requisite skills, sufficient external expertise—for example, in relation to the financial, legal and technical aspects of contract management—is obtained.

**Evaluation and succession planning**

Critical to the ongoing success of outsourced government projects or service delivery is the planning for completion of the initial contract. This needs to be taken into account at an early stage to ensure that there is a seamless transition between contracts (and service providers where necessary).

Contract succession planning and management policies need to identify the renewal options available to organisations and provide guidance on timeframes for ensuring service continuity. A recent ANAO audit found that in a number of organisations reviewed, succession planning and practices were limited to the rolling-over of contracts as they expired. The audit found minimal evidence of justification for
contract continuation or completion options; such as market testing, renegotiation, retendering, discontinuing the service and/or bringing the service back in-house.

Continuity of service is an imperative of contract succession. The ANAO has observed generally that large outsourcing exercises can involve the transfer of a significant number of agency staff to the contractor. By default, this transfer of staff achieves continuity through the corporate memory of those staff now employed by the contractor. However, if, at the conclusion of that contract, a new contractor is selected, the issue of knowledge transfer becomes more complex, particularly where the retained expertise for oversight and contract management purposes is limited.

Close attention must therefore be given to the transition arrangements, particularly the hand-over of the service delivery from one contractor to another. This is to ensure not only that there is a smooth transaction but also that the new contractor has the necessary expertise and knowledge to work within the corporate culture of the agency. A particular issue is the handling of residual value risk, that is the risk borne by the party taking over any capital assets involved. This is one of the many risks, referred to earlier, that needs to be addressed upfront in contract negotiations.

V. CONCLUDING REMARKS

I have covered a diverse range of outsourcing and contracting issues in this address but, for some, have merely scratched the surface while, for others, have had to leave the subject for another day. I stress that this selection is not indicative of their relative importance, particularly in relation to the range and complexity of different environments that characterise the public sector. The simple truth is that outsourcing and contract management have come to characterise the modern public sector.

While the move towards outsourcing of government services has been gathering momentum for a number of years, the trend now encompasses not just the support service contracts, with which most organisations are familiar, but also elements of public sector agencies’ ‘traditional’ core business. This trend is unlikely to reverse in the foreseeable future. It is therefore incumbent on APS managers to refine their skills and knowledge to embrace their role as managers of outsourced (contractual) arrangements, as well as being developers of policy and administrators of legislation.

Various governments continue to demand that public sector agencies strive to maximise overall ‘value for money’ for citizens. In recent years, the public sector has learnt to deal with citizens as customers and/or clients in terms of service delivery. Nevertheless, public sector management requires consideration not only of output costs (and/or prices) but also issues such as client satisfaction, the public interest, fair play, honesty, justice and equity. Adherence to public service values and codes of conduct is essential. Such imperatives raise the question of trade-offs between the nature and level of accountability and private sector cost efficiency which is essentially one for the Parliament and/or Government to resolve.

The ANAO’s audits have consistently illustrated the value of written, legally enforceable agreements that reflect the understanding of all parties to a contract and which also constitute the entire agreement between the parties. To do otherwise,
means that the documentary audit trail supporting the authority for the payment of public money and contractual performance requirements, including any sanctions and incentives, may not be adequate. The consequent result could be misunderstanding, confusion and even litigation between the contract signatories. Our audits also have recognised that contractual performance is maximised by a cooperative, open and trusting relationship between the parties. In some areas, this has focussed increased attention on the nature of networks and/or partnerships to ensure that all contractual obligations are met as well as delivering high quality, value for money services to citizens.

Contracting should not be an unnecessarily daunting process for either party. The ideal contracts are the ones that you can virtually leave in the bottom drawer but also be confident that, if a challenge were to arise, the Commonwealth’s interests are well protected. As is usual in most other activities of government, there is always a need to strike an appropriate balance between establishing and maintaining a sound contractual relationship and protecting the Commonwealth’s interests. Key elements of an effective contractual framework include:

- using risk management principles to underpin the contracting process;
- using relevant expertise (such as financial, legal and probity advisers), where necessary, to ensure that both the process leading to signing the contract and the contract itself complies with relevant guidelines and requirements;
- making provision for appropriate access to records and premises by agency management (and the Auditor-General) to allow them to have sufficient access, as necessary, to fulfil their respective accountability obligations; and
- establishing clear mechanisms for monitoring and assessing performance against the contract requirements, including consideration of sanctions and appropriate incentives.

Contracting, while providing the benefits of cost efficiency, maintenance of particular skills and enhanced service delivery, can expose the public sector to increased risk. Maintenance of key corporate knowledge and understanding of agency functions and operations is essential. In many respects, agency managers increasingly are not directly responsible for delivery of program outputs but remain accountable for both outputs and outcomes. Competent contract management is often the Commonwealth’s key means of control over its outputs and their contribution to required outcomes. The more ‘market-oriented’ environment is inherently more risky from both performance and accountability viewpoints.

The concerns noted by my Office, the Parliament and other stakeholders, particularly in the area of contract administration including the use of commercial-in-confidence provisions, show that the adoption of the outsourcing initiative has not been an easy process for the APS. These issues mirror largely the experience of other jurisdictions both in Australia and overseas. Therefore it is important that, in addressing our own difficulties, we look elsewhere and learn from the lessons of others.
As mentioned earlier, my Office is currently preparing a better practice guide on Contract Administration as a result of Audit Report No.12 1999–2000 Management of Contracted Business Support Processes. The guide will focus on Australian and international better practice in types of contracting arrangements, pricing arrangements, ongoing contract management and contract succession. It will be presented in the context of the overall risk management process promulgated by MAB/MIAC and underpinned by the Australian and New Zealand Risk Management Standard. As such, I expect that it will prove to be of considerable assistance to those engaged in contract management in the APS.

I hope that the various selected thoughts and insights provide useful input to discussions on a most important and timely topic that impacts on all of us in the public sector. I wish you well in your presentations and deliberations.
NOTES AND REFERENCES


11 For example, in October 1998 I tabled ANAO Report No.10 1998-99, Sale of One-third of Telstra. The audit concluded that, as an essential element of the outsourcing of project management for future Commonwealth public share offers, overall value for money could be improved by:

   • giving greater emphasis to financial issues when tendering for advisers;
   • encouraging more competitive pressure on selling commissions and fees;
   • paying fees only for services actually provided; and
   • instituting a more effective and commercial approach to administering payment for shares by investors.


14 Tran Minh (Senior Analyst - Gartner Group) 1999, ‘Outsourcing can refocus a business’, The Australian, 1 June (page 2).

15 This derives from the Financial Management Act Regulations 1997, in particular Regulations 8 and 9 that refer to the Commonwealth Procurement Guidelines—of which value for money is the overriding principle—and the efficient and effective use of public money.

16 Joint Standing Committee on Foreign Affairs, Defence and Trade 1998, Funding Australia’s Defence (page 35).

17 Tebbatt, Dan, 1999. ‘Goals the main outsource issue’. The Australian, 7 September (page O42).


27 ANAO, October 1998.
40 Ibid., (page 21).
41 These were the subjects of two Reports by the Audit Office of NSW: *Private Participation in the Provision of Public Infrastructure: The Roads and Traffic Authority*, 1994, and *Roads and Traffic Authority: the M2 Motorway*, 1995.
47 Published by the Department of Defence’s Organisational Effectiveness Branch as a supplement to the Commercial Support Program Update Edition 40, Winter 2000.
48 Department of Defence and Australian Industry Group Defence Council 2000, *Private Financing of Defence Capability*, Discussion Paper for a Private Financing Industry Workshop, Canberra, 14 March (page 4)—identified the following lessons, reflecting a large degree of consistency, from case studies:
   • *Know what you want, but avoid over prescription. Specify outcomes and standards rather than process.*
• Long term contracts, defined as at least 7 years, but usually in the 15 to 35 year range, are needed for the private sector to recoup investment.

• Assessment of projects should be based on the private sector’s cost of capital rate, which in turn is based on the project risk.

• Projects need to be aggregated to an economic size, rather than a number of small ‘packets’, taking into account the benefits of proposals over the life of the asset and the benefits to the organisation as a whole.

• Private financing involves higher initial transaction costs, and higher cost of finance, than traditional procurement, which need to be offset by whole of life savings and benefits. For this reason, private finance and traditional tendering processes should not normally be carried out in parallel.

• Contracts have generally led to improvements, either through savings or through an improved level of service.

• Risk assessment and management is critical to success.

• A centre of expertise is necessary in private financial policy and practice, as is ready access to external financial expertise, to effectively manage and assess privately financed projects.

• Competition needs to be retained in the marketplace as much as is practicable.


59 Ibid.

60 Minister for Finance and Administration and Minister for Employment Services 2000, Employment National to Continue Services, Joint Media Release, 2 February.

61 Ibid.


64 ANAO Report No.1 1999–2000, Implementation of Purchaser/Provider Arrangements between the Department of Health and Aged Care and Centrelink, Canberra.


See for example, CPSU v Stellar Call Centres Pty Ltd [1999] FCA 1224.


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Ibid. (page 32)

Ibid. (page 35)


See also the recent report of the Auditor-General for Western Australia 2000. ‘A Means to an End – Contracting Not-For-Profit Organisations for the Delivery of Community Services’. Report No.3, 3 June (page 27).

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Ibid, (page 3).

