

**REPORT OF PROCEEDINGS BEFORE**

**PUBLIC ACCOUNTS COMMITTEE**

**INQUIRY INTO PUBLIC PRIVATE PARTNERSHIPS**

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**At Sydney on Wednesday, 19 October 2005**

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**The Committee met at 9.15 a.m.**

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**PRESENT**

Ms N. Hay (Chair)

Mr G.J. Aplin  
Ms K.K. Keneally  
Mr G. R. Torbay  
Mr J. H. Turner  
Mr S. J. R. Whan

**GARY LEON STURGESS**, Executive Director, Serco Institute, 14 Orchard Rise, Kingston-upon-Thames, UK, sworn and examined:

**CHAIR:** Thank you for appearing before the Committee today. The Committee is pleased to hear your evidence today. I am advised that you have been issued with a copy of the Committee's terms of reference and also a copy of the Legislative Assembly Standing Orders 332, 333 and 334 that relate to the examination of witnesses. Is that correct?

**Mr STURGESS:** That is correct. I am executive director of the Serco Institute. Serco is a public service company in the UK, well, an international service company, with ninety per cent of its business in providing services to governments. In that capacity, we are actively engaged in public/private partnerships in the UK and elsewhere around the world.

**CHAIR:** Could you please explain to the Committee your role in PPPs in the United Kingdom and Australia?

**Mr STURGESS:** Well here in Australia, as Director General of The Cabinet Office and the then Premier's senior policy advisor, this issue became very active immediately upon the election of the Greiner government in 1988. The Harbour Tunnel deal had been done in 1987 and basically it was an industry trying to happen. There was a group of people trying to make money out of promoting public/private partnerships and I guess my initial engagement in this was a whole string of those people knocking on my door trying to convince the Government that this was a terrific way of getting round Loan Council, around the Borrowing Limits. I spent a lot of time explaining to those people that we thought the Borrowing Limits were a really good idea and we were not interested in using it to get around the constraints on borrowing that had been introduced nationally. It [private financing of public infrastructure] was a subject that I approached with considerable caution.

Of course, there were a number of PPPs (as they are now called) done in those days and inevitably I had a significant role in advising on the development of those early models. I left government in 1992, joined Serco as a non-executive director in 1993 and was travelling back and forwards to the UK in that capacity. So, I became increasingly involved in talking to the officials in the UK Treasury who were developing what there was called the Private Finance Initiative (PFI) and was in fact bringing Auditor General's reports from here across to the UK to discuss with them the kinds of issues that had arisen here. Then in 2000, I moved across to the UK and became a full time executive of the company and I have been actively involved in the creation of an industry association for the public services sector and I run the company's research institute, so I spend my professional career researching and discussing these issues and talking to government about how to do it better. So I am very actively involved in this issue.

Serco does a lot more than just PPPs. We are doing a lot of other complex partnerships but this has been such an important issue in the UK over the last twelve years, that it is a topic that it debated fairly frequently.

**Mr WHAN:** What sort of range of projects is Serco involved in, in terms of sectors?

**Mr STURGESS:** Serco is unusual in that its core business is defined as a set of competencies rather than any particular industry sector. The company was firstly really a technology business in the defence sector. Forty years ago they won a contract to build and operate the ballistic missile early warning system in the UK, the four minute warning, and that is a contract we still have. So they started out in defence and moved into science. We have quite a number of prisons and detention centres. Some of the prisons are done under PPP, others are just operational contracts. Educational contracts, hospitals (a number of hospital PFIs), defence facilities (including a defence college, the Joint Services Staff College, which was done as a PFI, so it is essentially an institution of higher education), the traffic control system for England and Wales (which was done under a PFI) the National Physical Laboratory, the metrology laboratory for the United Kingdom, which develops and maintains the standards for time, distance, mass and so on (in addition to contracting the operations, new labs at NPL were done under a PPP). So, a very wide reach.

**Mr TORBAY:** I have heard you talk about some of this previously and again thanks for being here and giving evidence, the UK is looked to as the model for PPPs given its history and your unique position with a good understanding of both, I would be interested to touch on how you think we have come along in the terms of PPPs - because in the early days there were some shocking examples - particularly the skills between the private and public sector, how that has in fact unfolded? Is the public sector, for example, skilled enough in terms of the negotiations? We have got some pretty topical issues on PPPs going on over here at the moment, but I would just be interested in your view, are we getting better at it and we draw on the UK experience and are there sufficient skills in the public sector to make sure that the private sector do not out-negotiate the situation which appears to be common amongst some of the high profile PPPs.

**Mr STURGESS:** I would suggest that New South Wales or Australia not beat itself up over those early days. I mean, you have just produced a report on private prisons - that is a PPP - and it was a great outcome. So there is a very strong history here: some have gone well and there has been difficulties with others and I think it is inevitable in the early stages of developing new techniques that lessons have to be learned. I think one of the difficulties here is that PPP was put on hold for a long time, so that whatever learning may have been done was lost and the lessons then had to be relearned. In the UK they have done over 600 [PPPs]- there has been a lot of this done.

Serco was an early participant in the hospital PPP market in the UK and in fact pulled back for a time because in the hospital sector in the UK decision-making is very devolved. You have individual hospital trusts and they might have several hospitals in the trust area and typically they will do one PPP in their entire lifetime. At that point in time the Department of Health had not developed a central commercial capability, so it was very devolved and it is an enormously difficult experience and costly, potentially very costly, when you do not have that learning. One of the conclusions that has been drawn about the most successful areas of PPPs in the UK and the less successful areas is that where there appears to have been greater success and greater value extracted, is where the decision making was fairly centralised. Roads and prisons are the two examples that have been discussed and in both those cases you had teams who were involved in repeated transactions - not only were the teams centralised but they were fairly stable so that in the case of prisons, the people that our negotiators were dealing with on prison number six were the same people who'd been there on number one, so there was lots of learning that went on, lots of discussions that did not need to be re-had because they had worked these issues through and they had learnt.

So I think that there are some important issues here for the Australian states where you have got a more devolved system. I think there are some important issues about having centralised skills.

**Ms KENEALLY:** Can I follow on with that, because some of the submissions that we have had have suggested some areas that are leaning towards that centralisation you were talking about and things such as standard contract clauses, the procurement processes, essentially a half baked idea put out will produce half baked results, but our procurement processes need to be more thought through. One of the submissions was arguing against the use of bid bonds. There were a number of submissions that were putting forward ideas of how government could better enact PPPs. I was just wondering if you could follow on with that centralisation theme, are some of these things like standardised contracts, are they more better thought through processing? Are those the things that have led to the central PPPs in the UK?

**Mr STURGESS:** is the answer is I think there are a lot of things that have contributed to it. On standard clauses there is a trade off. Standardisation is important. You can save an awful lot of money on lawyers and consultants by standardising what you can, but there is a trade off and if what you are wanting is innovation out of a particular PPP and it is large enough to warrant the transaction costs, then there is some benefit in allowing companies to experiment and come up with different proposals and allowing greater freedom. But for the vast bulk of PPPs there needs to be a move towards standardisation of clauses and there has to be a measure of central control over that. There has to be some central insistence. In the UK there appears to have been evidence of resistance of that [standardisation] for some time. I think they have now resolved that and we are seeing standardisation flow through but for a time there appeared to be still a desire to experiment with

‘making it different in our case’. Standardisation lowers transaction costs, it makes it less costly to negotiate.

**Ms KENEALLY:** Following on the innovation though, because one of the other things that the submissions were arguing was that in the procurement processes there needs to be a better flow of information between the government agency and the tenderers, the bidders, and I think the submissions would say they were arguing to relax probity rules, but that certainly seems to be where they were going. Tell me about the whole idea of the procurement processes, about the flow of information and whether or not they are well thought out when they are put out to tender. Could I have your comment on that as well?

**Mr STURGESS:** There is no doubt that with PPPs, because you are letting very long term contracts and because contracts create binding obligations, it is crucial that government thinks through very, very clearly in advance what it wants and what the implications are of specifying a particular set of outputs. Indeed, that is one of the great strengths, one of the great benefits of PPP, is that it has that forcing effect. It forces agencies to pause up front and think through very clearly what it is they want.

So typically what you find is that they [PPPs] have a slower start up period, because of this process of working out what is it we really want here and then going through a procurement and negotiation phase, and then a much quicker delivery. The construction period is typically much quicker and there is an awful lot of logic in why you would want to do things that way. It gets very expensive to keep changing your ideas in the course of the construction process. An awful lot of money is wasted.

**Mr TORBAY:** It must help when you are allocating risk too. I think there have been some problems of where you allocate the risk in the early PPPs, so surely that would help in measuring those outputs, as to where and how much it costs to consider the risk factors?

**Mr STURGESS:** Absolutely. I think dialogue between government and bidders is just really, really crucial and there is no doubt at all there are tensions between the way in which we in the West have constructed our procurement processes and the need for dialogue in using these particular tools. Indeed, the Serco Institute has done some work looking at our experience with bidding for large projects and drawing on an area of economic theory called Game Theory, trying to understand the kind of procurements which produce bizarre outcomes. There is a problem in economics known as the Winner’s Curse - the theory is that in certain situations the winner always loses, the winner always bids too much. The conditions for that are two-fold: one is that you have a very aggressive price-based auction; and secondly, that the bidders in the market have different understandings of what it is they are bidding for. In those circumstances, it really is just wild card as to who is going to win and what the outcome will be. The conclusion we have reached from that is that if you find yourself in a winner’s curse type situation - that the procurement rules have been designed so that are likely to produce that outcome - do not bid, because the winner is going to be completely random and the bid that is priced most recklessly will be the one that will win.

**Mr WHAN:** How does an agency managing that process avoid awarding the tender to a price that is unrealistic?

**Mr STURGESS:** There are several things. One of those is that it is crucial that the government agency understands clearly what it wants and then it needs to communicate that very clearly to the bidders. That cannot be just done through formal documentation. It will frequently need people with operational experience to be involved in the process rather than just bid technicians or procurement technicians. It will involve communications back and forwards between the procurement team and the bidders.

We have had a number of bids where we found when we put in our proposal, from the questions we were getting back from the customer, that the people involved [in the procurement] completely misunderstood the nature of the service in question, so that there was a need for us to explain to them much more clearly how this service area worked.

**Mr WHAN:** The customer was who in that case, not specifically, was it a government entity?

**Mr STURGESS:** It was a government customer and the team involved were external consultants and procurement specialists. They were not people with operational experience in the field, so they had a very theoretical view of how this service worked without any particular practical experience.

In that particular case I am thinking of they had constructed a process for a dialogue back and forwards that was fair between the parties and they got to learn more clearly from us why it was we were proposing. We had a chance to say to them, "We don't think you've quite understood what we have said to you" or rather, the implications of that and they got a chance to say back to us, more specifically than they could have said in a written document, "This is what we are in fact trying to achieve".

That dialogue is really quite crucial and I think that old-fashioned two-envelope State Contract Control Board-type bidding processes are not appropriate for these very complex procurements. Of course there need to be devices that address the probity questions - I mean I hope it would be taken for granted that I would be concerned about probity questions - but they cannot be used in a way that produces an outcome where private sector firms are bidding on specifications that they may have misunderstood.

**Ms KENEALLY:** What about the role of the PSC, the public service comparator, one of the submissions suggested that their evaluation should be made available to the tenderers so that the tenderers have better understanding of what the Government is trying to achieve.

**Mr STURGESS:** I cannot think of any reason why you would not make public sector comparator available. It is the same with the evaluation criteria. There are a lot of procurements conducted, even in the UK, where the evaluation criteria are not made available to the bidders. I cannot imagine why government would not want to let the private sector know what matters to it in terms of the [evaluation] weightings and so on.

The UK is moving away from having public sector comparators which is a bit unfortunate because, rough as they are, they are a useful device for giving some idea about what sort of savings have been made over what government thought it was probably going to cost. But the view has been taken that they [PSCs] are so rough and that really the point has been proven after six hundred projects, the view has been taken that they [government] should just have the competition and see what the best price is. As I said, this does have the unfortunate consequence that if you research the recent NAO reports in the UK, you will find less evidence in the last two years than there was previously of the level of savings that have been made.

**Mr WHAN:** Does that suggest in the UK now for most of these projects there is no option of government doing it itself, they are just ruling that out early?

**Mr STURGESS:** With PPP (as opposed to other forms of procurement), there was never an option. Scotland has invented a rather complex structure (and it is unclear whether it is going to work), which permits the in-house team to submit a late bid on the soft FM services. There is a hospital procurement going on at the moment - we must be very close to the submission date - for a PPP with soft and hard FM services, and the in-house team - who will not have capital to submit a bid on the construction and financing solutions - will have access to the private sector bids after they have been submitted, and will be able to submit a late counter-bid for the soft services.

It raises enormous competitive neutrality questions and the private sector is looking at it very, very closely. If this first one does not go well I would not be surprised if bidding for this kind of project is not vigorous in future. Normally, because of the huge capital funding issues associated with PPPs, there is not an in-house bid.

**Mr WHAN:** On risk, which was mentioned earlier on, allocation of risk in this process, have you got any thoughts on how you balance allocating risk, particularly when it is a risk to do with patronage? We have seen the full range in Australia of things where the Government has borne the risk of too low a patronage or usage to points where the contractor has borne the risk. How do you see that?

**Mr STURGESS:** The view that Treasury has reached in the UK is that there are some risks that the private sector cannot manage as well as government, and the example they have been giving in briefings recently is transportation projects. The UK has only done one private toll road, so they have not got a deep experience on that side, but on urban light rail projects they have accepted that the private sector will not generally accept the patronage risk.

Serco has two light rail projects in the UK. One of them, the Docklands Light Rail, does have some patronage risk, but this is a new development of the new financial district and patronage has been essentially an upward progression. The other one is in Manchester, and was to be re-bid with significantly expanded scope: neither of the two final bidders were prepared to accept patronage risk on that and the project is undergoing fundamental re-analysis at the moment.

When the fundamental driver of PPPs is to get spending off balance sheet, then the game is to shift as much risk as possible to the private sector. So procurement is no longer about optimising risk allocation, but it is about maximising risk transfer and in those circumstances the game can become: 'Can we push the private sector to take on patronage risk and how far can we push that?'

The danger with that is that private sector bidders, in the heat of a competitive bidding environment, can be pushed to take on risks that they cannot manage. One of the responsibilities of government is to conduct a procurement process that does not create this kind of 'optimism bias' (as it is called in the UK). The Victorian Treasury, some years ago, was re-looking at the Melbourne trams and trains bid, and coined the term 'bid fever': they acknowledged that they had generated bid fever on that particular bid and some very experienced companies had been induced into bidding a price that was uneconomic based around [assumptions on] patronage.

**Mr WHAN:** Based on unrealistic estimates of patronage?

**Mr STURGESS:** Yes, and the government can create a set of procurement processes that provoke the bidders in this very hot competitive environment into assuming risks that are not manageable. So there are some very important questions around the design of this [procurement processes], so that you get the right amount of competition but do not produce ugly outcomes.

**Mr WHAN:** From the point of view back in your public sector hat which you previously had, how would you see it from the taxpayers' side of things? Isn't it in the taxpayers' interest for government to try and shift as much risk as possible in that area?

**Mr STURGESS:** Not if it falls over. I think there are several reasons why it is not healthy. If you get a winner's curse situation, then there are going to be several things happen. One, the winner will come back to government and try to get you to assume some of the risk. That becomes dangerous, because then you get the problem that existed in the construction industry for many years, where the game is basically about contract variation: 'Let's bid a ridiculous price and then play the contract variation game afterwards'. Well, PPPs are meant to stop that kind of game but the trouble is that if the price is unviable, government is going to invite that [kind of behaviour]. Alternatively, the contractor will fall over and even if they are able to struggle on and just keep the thing together, if government wants a [contract] variation in the course of the thirty year life of that project, it will find a private sector party that is going to say, "Look, if you want to talk to us then let's talk first about price. We've been bleeding [financially] on this project for five years, so let's discuss that first."

So the other side that is enormously important about this is [Government] is not just conducting procurements. If you are doing this right, you are building markets and if you create a situation where the market is populated by people who are quite comfortable in engaging in predatory behaviour, then you have set up an unhealthy culture within that market. The construction sector, not

just in this country but in Europe and North America as well, is a classic example of this, where some very negative practices had built up over time and the entire industry seems to be caught in this negative culture.

That is bad enough when you are just building office buildings, but when you are delivering public infrastructure and delivering public services, this is enormously damaging. It is not a very healthy market if you have got any transfer of workers involved, where you are transferring workers from public to private sector, [if aggressive procurement processes] encourage winning contractors to treat those workers more harshly in the transition process..

**CHAIR:** That has brought us to the question I actually wanted to get some clarification on. Where you say it is critical to set up the contract process so it is clear about dealing with workers fairly - you appreciate there is a lot of unrest going on at the moment, certainly in New South Wales - can you clarify--

**Mr STURGESS:** In the UK there have been a number of initiatives. One comes out of a European law called the Acquired Rights Directive (so this was in a sense, imposed by European law), and then adopted in UK domestic law as [the scope of the directive] became clearer in what is called the Transfer of Undertaking (Protection of Employment) Regulations, or TUPE. What TUPE says is that when workers transfer from the public to private sectors under a contracting arrangement or when there is a transition, that it is not permissible to use the transmission as an opportunity to change terms and conditions.

You can sit down and negotiate with your employees and their unions afterwards and try to change terms and conditions as a normal industrial relations consultation, but the moment of transition, when workers are very weak, in that moment when they are transiting from one to the other, you cannot take advantage of that [weakness]. That is really now settled law and practice in the UK.

There were a couple of wrinkles developed over time where some companies, the unions claimed, were deliberately pricing their bids on the basis that they would be able to lay off a lot of the [transferred] workers and bring on new recruits with lower terms and conditions. The public industry in the UK has worked with the unions over the last couple of years to get a code of practice to stop that as well.

These are issues that governments should be addressing upfront.

**Mr WHAN:** So that should be something that is in the centralised framework.

**Mr STURGESS:** Through guidelines. It [transfer provisions] Transfer provisions are very important to contractors at the other end not so much with PPP contracts, but with more classic outsourcing contracts - when there is then a private to private transition. Because if the old contractor faces a huge redundancy payout and the same workers start the next day with the new one [contractor], then government will end up paying the higher cost, because, companies will just simply bid a higher price [anticipating the cost of] the redundancies they will have.

It makes good commercial sense for government to reassure the private sector about these transfer conditions. If you take our contract for the management of the National Physical Laboratory, there were two parts to it, there was the PPP but also some years before when we originally won that contract, we transferred across about five or six hundred scientists. These are some of the nation's leading scientists. We needed all of them to transfer. Losing two thirds of the nation's top scientists from one of its premier laboratories [in the course of the transition], would not have been a very good experience.

**Mr TORBAY:** All the intellectual capital gone.

**Mr STURGESS:** Exactly, so TUPE and good rules around transfer are also important for keeping your workforce intact, which if you are managing complex services, and you want to transfer

all that corporate knowledge, you want those people to come over. Any kind of transition of employment is very unnerving for employees. You want them to be reassured as much as you possibly can in the course of that process so that they keep doing their job and doing it well.

These issues are really quite important, quite fundamental and at least as far as companies like ours is concerned, we would prefer those issues to be addressed sensibly upfront.

**CHAIR:** Has there been a notable difference since this has been applied?

**Mr STURGESS:** TUPE has been in place since 1992/1995 - formally in 1992 and then it developed and was progressively applied. It took the heat out of that issue and rose again when the unions started to re-express concerns about the two-tiered workforce problem. But since the industry engaged with government and the unions to develop a Code of Practice [to deal with the two-tier workforce], the concerns around that have dropped off. TUPE certainly reassures the unions and removes that sort of controversy. After all these years, it is accepted that this is how it will be done.

**Mr WHAN:** I was interested in cost of capital, raising capital and in terms of private sector, PPPs versus more traditional government bonds and things like that. Is there in the UK a significant difference in that cost at all?

**Mr STURGESS:** There is a difference but as the market matures the gap narrows and what typically happens is that there is a higher margin to begin with as companies price in the initial risk. But once those risks have vested, once the building is complete and once the uncertainty around the policy has settled down, companies are able to go back and re-finance their debt and bring those margins down and take a profit .

That [refinancing] became a bit of a political issue and the government introduced a code of practice so that re-financing gains have to be shared between government and the private sector, but it is only a short term problem because the next time [a similar project is bid], the companies are bidding that margin in up front. So what happens is that as the market becomes comfortable with the policy area and becomes comfortable with government's intentions and the risks, that gets bid away. Obviously there are exceptions, but generally the efficiency gains from competition far outweigh any benefits in terms of the government being able to borrow more cheaply. If you are making savings in the order of twenty per cent, they really do just swamp whatever difference there is in government being able to borrow slightly more cheaply. You have got to look at both those factors.

**CHAIR:** Thank you once again for coming in and answering questions.

**(The witness withdrew)**

**(The Committee adjourned at 9.55 a.m.)**