



The Serco Institute

**Responses to Questions on Notice from
the Hon. Amanda Fazio MLC
27 March 2009**

1. Can you please explain the role of the Serco Group and the Serco Institute?

Serco Group plc is a publicly-listed, FTSE 100 international service company with annual turnover of £3,124 million in 2008. In 2009, it employs more 60,000 employees in 34 countries around the world. More than 90 percent of the company's revenue comes from contracts or franchises awarded by governments, covering a range of sectors that includes defence, aerospace and science, public transportation and traffic management, education, health, justice, and local government. Around 6% of Serco's revenue comes from the Asia Pacific region.

The Serco Institute is a research institution established by Serco Group in 1994. It continues to be funded by the company, although we are not part of its business operations. The Institute undertakes primary and secondary research into the conditions necessary for successful public service markets, and all of our research is released to the public. We have published extensively through independent think tanks and industry associations, and we work closely with Serco's competitors. (Indeed, our next publication, on the development of the UK prisons market, will be jointly published with two European prison companies.) The Executive Director is presently serving on the advisory board to projects based at the Harvard Kennedy School and the Royal Society in London.

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2. What prison and prison-related services are privately managed in the UK?

In the early 1990s, the management of four recently-constructed public prisons was competitively tendered and contracted to private firms. Subsequently when these contracts were re-tendered, two of these prisons were won by HM Prison Service, and are presently operated under quasi-contractual arrangements known as 'service level agreements'.

In addition, nine prisons in England and Wales have been designed, constructed and financed, and continue to be owned and fully operated by private providers under the so-called 'Private Finance Initiative' (PFI), a policy that is similar to public private partnerships in Australia. There are also two PFI prisons in Scotland, overseen by the Scottish Prison Service. Moreover, the government is in the process of procuring several more prisons in England and Wales under PFI.

Private companies manage four 'secure training centres', purpose-built facilities for young offenders up to 17 years of age, where the regimes are focused on education.

All court escorting in England, Scotland and Wales is undertaken by private firms under contract, and since it was introduced in 1999, the home detention scheme, which employs electronic tagging for monitoring of offenders, has also been operated by private firms, which not only supply and fit the devices but also monitor compliance.

There is also a mixed economy for secure mental health beds, with the independent sector supplying around 40% of medium secure mental places throughout the country. Finally, the private sector is involved in providing a range of support services in publicly-managed prisons, including drug rehabilitation and education and training.

Moreover, in the Budget released on 22 April 2009, the government announced that over the next three years 'the National Offender Management Service will run a competition for the management of five existing prisons and. . . all new-build prisons will be built and managed by the private sector'.¹

a. Does this include constructing prisons as well as operating them?

Yes. All new prisons constructed since 1997 have been designed, built and financed and are owned and fully operated by private companies. Government policy is that all new prisons will be constructed and managed by the private sector.

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b. Does this include prison-related services such as court escort services or perimeter security services?

See above. However, in the UK, there is no equivalent function to the perimeter security provided by private contractors in some NSW prisons.

c. What proportion of prisons and prison-related services are privately managed?

As far as fully-managed prisons (contracted and PFI) are concerned, the percentages fluctuate somewhat due to overcrowding, however around 8% of prisoners are kept in PFI or contract prisons. This percentage is expected to increase under existing proposals for new PFI prisons and plans announced in the 2009 Budget. As noted above, the independent sector accounts for around 40% of medium secure mental health places.

However, there is a wide range of support services in publicly-managed prisons that are provided by private and not-for-profit organisations, including drug rehabilitation and education services. Regrettably, there does not seem to be quantitative information published on these services.

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3. Is private management of prisons and prison-related services generally well-received in the UK?

The contracting of prison management has been opposed by certain interest groups, although the lack of controversy over the fifteen years that private companies have managed prisons in the UK has meant that it is not a matter of great public interest.

There has been strong support among policymakers in the Home Office (and since recent departmental changes, the Ministry of Justice). However, there is still opposition in some quarters of HM Prison Service.

Public sector unions have continued to oppose the policy, although as noted in our original submission, some leaders of the Prison Governors' Association have publicly acknowledged the benefits that competition has brought. The unions who cover staff in the privately-managed prisons are quietly supportive.

As noted in our original submission, prisoners have been overwhelmingly supportive of the contract prisons.

Prison reformers have remained sceptical, although they have had very little to say on the policy, and some of them have made favourable comments.

Some parts of the academic community have commented favourably supporting the reforms associated with prison contracting, with little dissent. The most consistent student of prison contracting has been Professor Alison Liebling at Cambridge (referred to a number of times in our original submission).

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4. What do you believe to be the major advantages and disadvantages of privatisation of prison and prison-related services?

As explained in our submission, and discussed further below, we believe that the benefits of private sector involvement in prison and prison-related services come through competition and contracting rather than through privatisation per se.

As we explained before the committee, the Institute studies competition and contracting across a wide range of sectors, and the following comments are based on this much broader study. The lessons, however, are directly applicable to prison contracting.

4.1 Advantages

(i) Value for money: This question was addressed at some length in our original submission. We would stress, however, that the evidence demonstrates value-for-money from competition in public services.

In November 2007, the Serco Institute published a survey of 196 studies by government and academic sources from 12 different countries, across five sectors. These sectors were chosen because they had produced the largest number of studies and the most vigorous methodological debates. In brief, the Institute's survey concluded:

- In defence support, studies from Australia, New Zealand and the United States reported savings in the range of 20 to 30 percent, although in some cases, they had been much higher.
- In health support services, financial benefits in excess of 20 percent had been reported in England, in Australia and in Denmark. However, in other jurisdictions, where competition had been pursued less vigorously, the savings did not appear to have been as great.
- Of ten studies of US prison contracting, all but one found positive benefits associated with contract management, and these were mostly in the range of 5-15 percent. The financial gains in the UK appear to have been more than 20 percent, and perhaps as high as 30 percent.
- Competition and contracting in household refuse collection had been most extensively studied, with financial gains in the majority of the studies in North America, the United Kingdom and various European countries clustering around 20 percent.
- The results from the study of municipal services were more mixed, in part because of the much wider range of services involved. The range extended from 5 percent to as much as 25 percent in some studies. Results from the use of compulsory competitive tendering in UK local

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government indicated savings that were towards the bottom end of this range.²

It has been some years since this question was studied closely in Australia, and the last major study was undertaken by the Industry Commission in 1996. A survey of 203 empirical studies from Australia and overseas reported that 75 percent of studies found savings and the savings ranged from 10 to 30 percent in over half the services studied. A survey of Commonwealth Government budget sector agencies undertaken for the Industry Commission found average savings of 16 percent. Moreover, savings tended to accrue over time.³

However, in recent literature surveys, Australian academics, Jensen and Stonecash wrote: 'while there is still some ongoing debate about the magnitude of the cost change associated with outsourcing, there seems to be some consensus about the direction of the change'.⁴ And Graeme Hodge, from Monash University's Mt Eliza Business School, concluded that there were real costs savings of around 8 to 14 percent.⁵

(ii) *Payment on performance*: Contracting enables government to pay for outcomes and outputs rather than just funding inputs. Government pays only for the delivery of services to a standard that has been specified in advance.

(iii) *Service improvement*: Competition and contracting can be used to bring about an improvement in service quality, although for the most part, governments have not used it for this purpose, most often using competition to drive through cost savings.

We would also note that it is more difficult to measure qualitative change, so that much less effort has been spent in grappling with this question in academic and governmental research. However, there are two market sectors in the UK where some research has been done, and from which conclusions might be drawn about how competition and contracting might be used to improve the quality of public services. One of these is prisons, and this was addressed in our original submission; the other is Local Education Authorities.

(iv) *Risk transfer*: One of the most powerful explanations as to why governments have turned to the private sector lies in risk management. Over the past decade, one particular form of public sector procurement – public private partnerships, involving private sector design, construction, financing and maintenance or operation – has received a great deal of attention around the world. In large part, this has been because of its effectiveness in transferring the risk of delivering on-time and on-budget.

One of the greatest difficulties in undertaking studies of this kind lies in good quality data concerning the performance of government construction using traditional procurement regimes. In the UK prisons sector, however, there was

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high quality data because of a NAO* study of a major programme of construction undertaken by HM Prison Service several years before the introduction of the Private Finance Initiative.

- Of the seven traditionally-built prisons, not one was completed on time, with an average overrun of 13 percent; of the first seven PFI prisons, all were ready at or before the date specified in the contract.
- On average, construction costs of the seven traditionally-built prisons exceeded estimated costs by 18 percent. By definition, none of the PFI prisons cost the government more (since that is a condition of a PFI/PPP contract).
- Under PFI, construction times fell by 40% compared with the seven traditionally-built prisons.
- Over the first three years of PFI, total costs of operating a PFI prison fell by around 40 percent.⁶

Two of the more significant studies on on-time/on-budget delivery of PFI/PPP projects have recently been published in Australia. In 2007, the Allen Consulting Group undertook a study of 21 PPP projects and 33 traditional projects, and concluded:

- Traditional projects were found to have cost overruns of 11.6 percent, while the extra costs of the PPP projects amounted to only 1.2 percent;
- On a time-weighted basis, traditional projects averaged a 23.5 percent time overrun, while the PPP projects were, on average, slightly ahead of time.⁷

Associate Professor Colin Duffield at the University of Melbourne has recently published another study, of 25 PPP projects and 42 traditional ones.

- PPP projects had an average cost escalation post-contract execution of 4.3 percent, compared with an average of 18 percent for the traditional projects;
- Once PPP projects reached financial close, there was on average, a 2.6 percent delay, compared with 25.9 percent during the construction phase for traditional projects.⁸

It is now generally recognised that with most public services, commissioners cannot shift the ultimate risk of delivery. If a service fails to deliver what the public expects, then politicians and public officials will be held to account by the parliament, the media and the public at large. This does not mean, however, that it is not possible to shift a great deal of performance risk, and if supervised well, contracting can offer a much more effective way of managing the ultimate risk of delivery. PFI/PPP contracts are a good example of how this can be done.

* National Audit Office.

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(v) *Increased accountability*: Enhanced accountability is an area where there is considerable anecdotal evidence of benefits (and was addressed in the original submission and is addressed at greater length below).

(vi) *Strengthening core services*: In some areas, competition and contracting have been actively used to increase the number of trained, warranted and/or uniformed personnel capable of being deployed on front-line duties – referred to in the military as the ‘tooth-to-tail ratio’.

The problem of providing professional logistical support to front line personnel has emerged in recent years as an issue in policing – highly-trained police officers waste hours each day grappling with paperwork, and with increased accountability, the challenge has become even greater. The growing complexity of support functions had added to this problem – instead of recruiting professional facilities managers or IT specialists, police forces have continued to employ men and women who have been trained for law enforcement to undertake these roles. It is for these reasons that civilians (including contractors) have been increasingly used to deliver support to the police.

Prisoner transportation provides a well-documented example of this same approach. A study by the Scottish Prison Service in December 2006 concluded that the centralisation and contracting of prisoner escorting had released about 300 police officers and 200 prison officers to undertake core duties.⁹

(vii) *Enhanced capacity*: Some public services are inherently peaky, and it is not in government’s interest to employ all of the staff necessary to deliver service levels at the height of demand. Military services are a classic example, which is why governments draw heavily on reservists in time of war and the private sector in support and logistics.

In Japan, one of the primary drivers of private sector involvement in prison management has been a legislative ceiling on the number of uniformed prison guards (who, by law, must be state employees). In that case, the use of the private sector to provide support services (including social services and perimeter security) has enabled government to expand its prison estate to address overcrowding without breaching this ceiling.

(viii) *Enhanced capability*: In some cases, governments have elected to use contractors as a means of accessing specialised capabilities that it does not need to possess in-house. Information technology (and the associated support services) is perhaps the most obvious example of this phenomenon. Given the highly technical nature of these services, the substantial commercial risks and the high mobility of staff, there are few reasons why government agencies should deliver these services in-house.

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(ix) *Stimulating innovation:* The incremental nature of service innovation makes it extremely difficult to study, although the fact that large savings are being delivered as a result of competition and contracting suggests that significant innovation must be taking place. It is most obvious where major technological breakthroughs are involved, although it is not confined to those areas. As explained in our original submission (and developed somewhat more below), the introduction of prison contracting in the UK in the early 1990s was associated with significant innovation in design, construction, technology and regime.

Public service markets stimulate innovation by insisting that reform proposals are developed in a competitive environment – each bid team develops its solution knowing that at that same time, alternative providers are working on superior proposals. Moreover, over a mere consultancy contract, each provider knows that it will be required to implement its solution.

Contracting also allows innovation to be introduced within a single institution, with the financial and reputational risks largely borne by the private provider. Once they have been successfully piloted within the contractual environment, new ideas can be disseminated across the rest of the prison system.

4.2 Disadvantages

Perverse incentives: Any system that provides powerful incentives to reform and improvement, if done well, must also have the ability to stimulate negative results if done badly. Good design and management of the procurement process, and of the contract itself, are essential if public service markets are to serve the public interest. (Of course, this is a problem with any system of performance targets with associated financial rewards and penalties.)

Transaction costs: Conducting a competition for the right to manage a public service costs money, and in the case of contracts for complex services with significant risk transfer, these costs can be considerable, not only on the part of government but also on the part of bidders. It is important that the anticipated benefits outweigh these costs.

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4a. Could you please elaborate on your discussion around quality of life for prisoners (page 12 of the submission)

In our original submission and in our evidence to the Committee, we argued that government should use the opportunity created by competition and contracting to demand higher standards of private companies involved in the management of prisons.

When prison contracting was first introduced in the United Kingdom in the early 1990s, the Home Office used the opportunity created by this fresh start to introduce a revolution in prison management. Contracting was used to import new prisoner management regimes into the British Prison Service.

In large part, these reforms were concerned with improving the quality of life of prisoners, from structural changes such as the number of hours spent out of cell and engaged in purposeful activity, through to relational issues such as officers calling prisoners by their first names.

The reasons why a focus on quality of life should be a central issue in prison management in general (and prison contracting in particular) is a complex issue that warrants an extensive submission in its own right; it can only be addressed here in the most general of terms.

At its most basic level, this is a question of fundamental human rights protected by international law. Traditionally, these issues have been addressed through the Universal Declaration of Human Rights, which refers to 'inhuman or degrading treatment or punishment'. In future, it will be covered by the Optional Protocol to the Convention against Torture and other Cruel, Inhuman or Degrading Treatment or Punishment, which the federal government has stated that it proposes to ratify.

A discussion of the quality of life of prisoners might also include other basic human entitlements such as access to legal and medical advice, security against physical assault by prison staff and other prisoners, the provision of a nutritious diet and clean and hygienic facilities, and limits to overcrowding. At this level, the question of quality of life is an instrumental one – if not addressed, persistent failure to meet these standards can lead to a breakdown in prison discipline, and has in the past contributed to protests and riots.

However, the quality of the prisoners' life is also a factor in successful resettlement and rehabilitation. As explained in our original submission, the reforms introduced by the US Federal Bureau of Prisons in the 1970s and adopted by the contract prisons in the UK in the early 1990s – unit management and direct supervision – were driven by an attempt to 'normalise' the prison

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environment, partly in a belief that this would assist in the resettlement of offenders at the end of their custodial term.¹⁰ A prison regime where the inmates are out of their cells for twelve or fourteen hours a day and engaged in more hours of purposeful activity is likely to make a greater contribution to rehabilitation than one where prisoners are locked in their cells for seventeen and a half hours a day.

Finally, some have argued that governments also have a responsibility for the 'moral performance' of prisons, among other things, the treatment of prisoners with respect and decency. In the UK, the work on moral performance has been led by Professor Alison Liebling at the University of Cambridge, based in large part on surveys conducted with prisoners and prison officers. Her list of what matters in prison includes respect, trust and the quality of relationships, a sense of fairness, opportunities for personal development and contact with family.¹¹

5. Can you please elaborate on your statement that 'competition delivers value for money benefits, not privatisation' (page 5 submission)

(i) If a contract is awarded to a private company to manage a prison without a competitive tender, there is no reason to expect that this will yield significantly better value-for-money. It is competition that motivates providers (public or private) to innovate.

By way of example, a tender for the management of a 400-bed female correctional facility at Otter Creek, Kentucky in June 2005 closed with only one response. The tender documentation had disclosed the public sector comparator, and the bid was 10% less than the comparator (as winning bids are required to be under Kentucky law), less a small amount for overheads that would be included in the calculation of the cost of contracting. However, the Auditor found that the Department had under-estimated the costs for monitoring and administration, and when a more reasonable estimate for overheads was included, the Otter Creek bid was only 7.5% less than the public sector comparator, rather than the 10% required by law.¹²

In this case, the absence of competition from other providers, and the loss of competitive tension caused by disclosure of the public sector comparator, resulted in the sole bidder submitting a price that they believed to be just low enough to meet the legislative threshold.

(ii) Conversely, where public providers are allowed to submit a bid in a competitive tender, they are sometimes able to deliver a more cost-effective solution than any of the private providers. The possibility of losing the bid motivates them to search for efficiencies and innovation that they would not otherwise have explored.

In the UK (as noted above), two of the original contract prisons were won by the Prison Service upon rebid, by offering better value than the private sector. Unfortunately, there has been no ongoing study of the performance of these two prisons, and a recent analysis of one of them, undertaken for a government inquiry, found it difficult to calculate whether savings had actually been delivered. Indeed, after a great deal of analysis, it reported 'a gap between the revised cost identified above through what had been commissioned in accordance with the service level agreement, and present funding levels'.¹³

The benefits of competition in prison management have also been acknowledged by a group of scholars associated with the US Federal Bureau of Prisons. In spite of having argued vigorously that there is no evidence in North America that privately managed prisons are more cost effective, these sceptics have acknowledged the possibility of a contestability effect, recognising 'the

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disciplinary power of the market in the long-run' and that 'actual or threatened privatization and the corresponding competition it generates. . . provide public managers with additional leverage over public workers and unions.'¹⁴

Studies of the introduction of competition into other public services have also found significant value-for-money improvements when the in-house team wins the tender. For example, a study of compulsory competitive tendering in North Ireland in the 1990s found cost savings in refuse collection and street cleaning, even though all of the services put to competition were won by in-house teams. Initial results suggested average savings of around 25%, although later analysis suggested much lower gains.¹⁵

(iii) Quite apart from the motivating effect of a competitive tender, there is evidence that – at least over the short term – the mere threat of competition will have an impact in bringing down costs in a publicly-managed prison. In economic theory, this is known as 'contestability'.

The best evidence of this in the prisons sector probably comes from the 'Way Forward' prisons in NSW, where the Public Accounts Committee found in 2005, that the threat of competitive tendering had contributed to new workplace agreements with substantially lower sick leave and overtime costs.¹⁶ Having spoken to senior NSW government officials at the time and since, we would argue that there is little doubt that it was the threat of competition that contributed to these value-for-money improvements.

However, the effectiveness of contestability relies heavily on the credibility of the threat, and ongoing failure to conduct an actual competition where external providers are perceived as having a strong chance of success will result in the loss of competitive tension.

(iv) *How* competition works in public service contracting has been little studied. Most studies are content to make oblique references to competition tension or the discipline of the market. The Serco Institute has undertaken original research in trying to understand what happens with competition and contracting for public services that makes the difference:

A fresh start: At least some of the benefits of competition and contracting seem to come from the opportunity that they provide for an organisation to press the reset button and make a 'fresh start' with a service that was performing poorly or just coasting. In this sense, competition and contracting appears to be a successful example of 'zero-base budgeting' which was pursued, largely unsuccessfully, in the 1980s.

One study suggested that in (publicly-managed) prisons, change is faster 'when sufficient numbers of new staff are transferred en masse from the training college or from another establishment'.¹⁷ This may be one of the reasons why

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competition and contracting seem to deliver transformation in organisational performance and culture. In Australia and the UK, prison management companies elected to recruit their custodial staff in the local community, rather than drawing on professional prison guards from the public sector. This enabled them to introduce a radically different culture into the contract prisons from the outset, one that was immediately identified by prison inmates.

Diversification: Some of the benefits may also come from introducing heterogeneity into the system. Some organisational theorists have argued that a modest level of personnel turnover in a system, involving the introduction of participants who are not as deeply socialised with prevailing norms, has the effect of increasing exploration and improving aggregate knowledge. From this perspective, it may matter less that the new entrants are experts in the field than that they bring a different perspective. The gains to the system come from their diversity.¹⁸

There is some evidence that such a process may have been at work in the UK prison sector in the late 1980s and early 1990s. Experienced (i.e. well-socialised) prison administrators took the view that it was unwise to encourage close association between prisoners and prison officers, opposing suggestions that prison officers wear name tags and call prisoners by their first names. It was widely believed that it would be unwise to introduce significant numbers of female prison officers into male prisons.

Prison management companies introduced each of these reforms from the beginning, contributing to a radical transformation in prison culture, many of which have since been adopted more broadly by the Prison Service.¹⁹

A 1985 Rand study into the US federal government's A-76 program found that private contractors won competitive tenders more often than in-house teams. In trying to determine why this was so, Rand focused (among other things) on the ability of contractors to design a solution tailored to the task as described in the statement of work (SOW), rather than being influenced by traditional work practices (as in-house teams often did).

For example, at two bases we were told that government employees often do poorly in bidding because they tend to bid on the task of maintenance as they have always done it, whereas contractors bid on the task as it is described in the SOW. The task described in the SOW generally requires less work than government employees understand to be customary for vehicle fleet maintenance. As a result, government employees bid to do more work than do contractors, at a consequently higher price than the contractors bid. . . In addition, it is difficult for government managers to drastically rethink the staffing requirements they have been using for years. In many cases, this will mean loss of jobs for highly valued employees. Finally, although the designers of performance work statements talk in terms of 'throwing away the rule book' when preparing bids, long-time government employees are sceptical that this can be done with impunity.²⁰

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Mandate for change: Under market-testing, even where the in-house provider wins the contract, the fact that the management team has secured (or refreshed) its right to manage following a competitive process, bestows upon it a mandate for change. This may give managers the authority to renegotiate the implicit terms and conditions that tend to accumulate over time in mature organisations through a process of accretion.

Organizational theorists speak of 'psychological contracts' in employment relationships, defined as 'a series of mutual expectations of which the parties to the relationship may not themselves be even dimly aware but which nonetheless govern their relationship to each other'. These expectations are largely implicit and usually develop outside the formal employment relationship.²¹

Psychological contracts are essential to the effective working of a complex organisation – the written contract of employment is simply too cumbersome to allow management and staff to adapt to changing circumstances day to day. However, if they are not periodically reviewed, they can also result in organisational sclerosis, and management may find itself incapable of refreshing the organisational structure and culture over time. The fact of winning a contract through competition may give senior management the authority to refresh the psychological contracts.

Requirement redesign: Competitive tendering requires the commissioning agency to prepare a detailed statement of requirement, which has the effect of focussing attention on the purpose, and the scale and scope of the service in question. In some cases, this is associated with a shift from process to a performance culture. In its 2001 report on Public Private Partnerships, the British centre-left think-tank, the Institute for Public Policy Research wrote:

A major potential benefit of PPPs is that they can help government to focus more clearly on the services people want, rather than simply managing existing forms of service delivery. . . . Public managers often comment that attempting to specify the nature of a planned service formally is a challenging experience – forcing out in the open issues which would otherwise remain hidden. This is an indication that the commissioning process can prove a highly effective way of concentrating minds on how to shape services to improve outcomes.²²

Solution design in a competitive environment: It is well understood that in markets for consumer goods, competition forces suppliers to respond to and, indeed, to anticipate the needs of their customers. Competitions perform the same role in the public sector – an open tendering process demands that competing providers develop innovative solutions in a competitive environment, where each bid team knows that other highly experienced teams are at the same moment in time developing alternative solutions to the very same set of requirements.

Contractual shield: Some of the Institute's research suggests that the fact of negotiating and signing a contract (or a service level agreement) may have the

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effect of increasing managerial autonomy. Our work in this field is based on a study undertaken in 2004 and 2005 with contract managers who had previously supervised the delivery of a similar service within the public sector. This began with a scoping study with 13 contract managers with a public sector background, and was followed by an anonymous, quantitative survey of 151 contract managers, 96 from the public sector and 55 with a private sector background. In the case of the former, these were the same people, managing the same jobs, but in two very different organisational environments.²³

Respondents told us that they had more autonomy and they felt more personally accountable under contract. In essence, the fact of winning a competitive tender and then negotiating and signing a formal contract created space within which the manager was permitted to manage. The contract served as a shield, and this 'contractual shield' mattered because it gave them greater scope for innovation, and the authority to respond quickly to new challenges as they arose. They were also able to build their own management team, hiring was quicker and easier, and management was much more personal.

In October 2007, the Confederation of British Industry's *Business Voice* magazine interviewed Vicki O'Dea, the director of HMP Ashfield, a prison and young offender institution managed by Serco.

Betraying scant nostalgia for her 19 years in the Prison Service, she says that she finds working for a private company 'liberating'. 'Don't get me wrong, there is a lot that's good about the public service: staff training and development, race relations, offending behaviour programmes. And it does teach you to use your resources well, human or otherwise. But everything is made so difficult. If you need something, you spend time writing a business plan, persuading the area manager, and so on. Now, I just go and buy it.'

At first, such spontaneity seemed odd. O'Dea recalls a seminal moment soon after her arrival when she was showing around a Serco board member and mentioned how she'd love to soften the staff uniform. 'Why don't you?' he asked. 'Only then did it sink in that I no longer had to consult the Prison Service,' says O'Dea, whose hands-on senior managers also now wear the uniform.²⁴

In the UK, a number of official inquiries have commented on the inefficiencies generated by ongoing political intervention in service delivery, and the continuous stream of detailed instructions and demands from officials in head office.²⁵ Contracting demands that policymakers make a clear decision about their desired outcomes from a service, and then to step back to allow room for providers to deliver. While there may still be a need to address urgent and unexpected issues, with a contractual shield, the opportunity to intervene on a daily basis is considerably circumscribed. Managers are free to manage.

Personal accountability: At the same time, respondents to this survey reported that they felt much more accountable under a contractual model of service delivery than under traditional arrangements. In particular, they described a form

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of accountability that was more personal than that which existed under traditional public sector management.

Under a contract, accountability was also sharpened and in part this was because the contract served as a shield. Accountability within the traditional public sector model was described as being somewhat like a layer-cake:

It's significantly more challenging in the private sector, and you can't hide behind anything. . . whereas, I think in the [public sector], you're just one of the many layers and it's very easy to blame the layer above you or the layer below.²⁶

By contrast, a contract was relatively self-contained, like a balloon, with only one way in or out – through the contract manager. As a result, the contract managers reported that they felt much more personally accountable.

Another important source of transparency lay in the existence of key performance indicators, with associated financial rewards and penalties. Some of the respondents reported that while the performance measures were virtually identical to those that they had used in the public sector, there were direct financial consequences for the failure to perform. This meant that managers needed to understand what was driving performance so that they could implement remedial change. As two of our respondents said: 'It means you really know your business'.

Because the management information systems are far superior in this [contract] than any other [comparable service] in the public sector, I have far more information about the performance of what is going on, so if I do want to put some time and energy into focusing on one specific area I know exactly where to look.²⁷

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6. Submissions to the Inquiry have raised the difficulty of comparing costs of publicly and privately managed prisons.

a. Do you share this view?

We agree that without careful research design, it can prove difficult to compare the financial performance of different prisons. This is not only a problem when comparing public and private prisons, but also when seeking to contrast the performance of two or more public facilities. There are two principal sources of this difficulty:

(i) 'Apples for apples' – for the financial performance of two prisons to be compared, it is necessary that they are similar enough for the benchmark to have meaning. However, it is rare for two prisons to be sufficiently alike in age, size, location, role and population for them to be compared based on the raw data alone.

One solution lies in adjusting the data for one of the prisons to take into account these differences, although inevitably this results in debates over assumptions and methodologies.

Another way of overcoming this challenge lies in comparing the same prison before and after competition (or privatisation); however this approach has also proved to be controversial, since it is rare for the same institution to retain the same profile following such a fundamental change.

A third solution lies in constructing a set of hypothetical accounts based on a prison of exactly the same profile, although once again, this leads to debates over assumptions and methodologies.

(ii) Quality of data – the second major source of difficulty lies in the quality of the financial information available. This is sometimes a problem with information about the costs of privately-managed prisons, although if what is being compared is the cost to government (rather than the cost to the operator), then government usually has reasonably high quality information to hand.

However, a number of studies have acknowledged that the quality of data in publicly-managed prisons is often quite poor. This is sometimes because some support services – utilities, legal advice and some pension costs – are provided at no cost by other government departments or agencies. It is sometimes because their financial accounts are constructed differently from private businesses. Capital costs – amortization of real estate and construction costs, and depreciation of major equipment purchases – are often omitted. And fringe benefits, particularly unfunded pension liabilities, are often not included. Greater

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attention is usually paid to administrative overheads and oversight functions, but these sometimes remain uncoded.²⁸

The 2007 study by Lord Carter of Coles into the management of HM Prison Service (in England and Wales) commented on the quality of the financial information available, even in the case of a public prison (HMP Blakenhurst) operated under a 'service level agreement' (or quasi-contract) following a successful competition by the public sector.

... the Review has found a gap between the current cost of HMP Blakenhurst and the Review's assessment of the prison's cost based on an analysis of cost increases at that prison since 2001. This gap represents the funding of services within HMP Blakenhurst allocated in addition to the terms of the original service level agreement.

The majority of this gap represents the provision of staff and officers within the prison who are working toward the delivery of services. On this basis, immediately extracting this money from the prison would cause a number of operational difficulties.

The Review recommends that the government should build on this work and develop an action plan to reduce service levels, without compromising safety and decency, to that assumed in the service level agreement cost, and making choices about the services to which scarce resources are allocated to achieve specified outputs and outcomes.

Owing to the differences between prisons and the quality of existing financial management tools, locating and validating the cost of HMP Blakenhurst has proved time-consuming. Given this, it will be difficult to extrapolate this figure across the remainder of the prison estate without significant further work.²⁹

In 2007, the Institute reviewed 43 comparative studies of prison contracting from four different countries covering a period of around 25 years. For the most part, these studies were not sufficiently robust to allow a meaningful comparison of publicly and privately-managed facilities, although some were clearly more informative than others. Our conclusion was that some of these studies could be used to provide insight into comparative efficiency. In some of the Australian examples (and Junee prison is one such), the cost differences were so great that it is doubtful that differences in the ages and roles of the prisons could not possibly account for them.

In particular, we were impressed with the study commissioned by the UK Home Office in the early 1990s, which selected several comparable public sector benchmarks for each of the contract prisons. The comparisons were made over four years, so that they were less likely to be subject to periodic distortions, and they relied on a consistent methodology that had been developed and debated in advance.³⁰ This study was discussed in our original submission.

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b. What is the best means by which the comparative costs of public vs private can be measured?

We would recommend that a methodology similar to that employed by the Home Office be employed. In the case of Junee prison, one or more public sector benchmarks should be selected with profiles that are as close as possible to Junee. Comparisons should be made over several years.

Government would need to develop a chart of accounts for these comparators so that their financial and operational performance can be compared as closely as possible. This will require assumptions to be made about capital costs, overheads, taxation and certain indirect labour costs such as pensions. It is inevitable that there will be a subsequent debate over these assumptions, however this should be welcomed as making a contribution to a more robust analysis.

If the NSW government were to proceed with a competitive tender for Parklea and Cessnock, there would also be an opportunity to compare these facilities before and after the transition, although of course, this would require the government to prepare a set of accounts and performance measures that captures the current state of these two institutions, prior to contracting the services.

There would also be an opportunity for government to study the changes that are introduced in these two prisons as they are being made, and the relative contributions that these make to the increased efficiency and performance of these facilities. To our knowledge, there is only one example of such a study in the English-speaking world – one undertaken by the Australian Graduate School of Management into a New Zealand defence contract.³¹

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7. In addition to personnel cost savings, what other savings might be realised from contracting prison management? (page 11 of submission)

As noted in our submission, the vast majority of savings – no matter how they are effected – will manifest as lower personnel costs. This is for the very simple reason that prison management is a human service, which necessarily involves a great deal of person-to-person interaction.

Private prison companies have introduced significant innovation into the management of prisons in the UK:

- new physical designs – radial design and open association areas;
- new construction techniques – the use of prefabricated materials and the development of new models for commissioning (or starting up) a new prison;
- new technologies – CCTV cameras and electronic keys;
- new regimes – direct supervision and the structured day; and
- cultural reforms – employment of female officers, changes to staff/prisoner relations.

In most cases, these reforms have been translated into lower staff/prisoner ratios. However, in Western Australia, the government used some of the productivity savings to employ more teachers and raise education levels for prisoners. And of course, efficiencies in physical design and construction translate into lower capital costs.

The only other area where efficiencies have been indicated is in procurement of goods and services, but these have made only a small difference to the overall cost of operation.

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8. What do you believe to be the system-wide benefits of privately managing a portion of prisons in a jurisdiction (page 28 of submission)?

It has been suggested that one of the advantages of opening up a monopolistic system to competition may be that the rest of the system 'learns' from the changes introduced at the margin through competition and contracting.

As noted in our original submission, there have been several attempts in the United States to study this effect, comparing the financial performance of states that rely more heavily on prison contracting with those that do not. As we noted, those studies have found a statistical association but not a causal relationship. On the other hand, practitioners and academics who have studied prison contracting have offered anecdotal evidence of systemic effects.

One would expect that the creation of an independent financial benchmark would assist in providing downward pressure on costs, an effect referred to in the economic literature as yardstick or benchmark competition. This concept was first introduced in utility regulation in the 1980s: 'What the regulator needs is some relatively simple benchmark, other than the firm's present or past performance, against which to evaluate the firm's potential. With such a benchmark, he can decide what the firm's costs ought to be, and set the price accordingly.'³² One benchmark suggested for private utilities in North America was a state-owned firm in the same line of business; the preferred solution lay in comparing similarly regulated firms to each other. (Utility regulation bears some characteristics to long term contracts for complex public services such as prisons.)

Benchmark competition seems to make a difference even where quality standards and not just price are being compared. Recent research into contaminant violations in water utilities in North America, found little difference between private and public water systems. However, the study did find that 'water systems in counties in which each water system tends to serve a smaller share of the county population have fewer violations'. Moreover, compliance was greater where providers were obliged to disclose test results to consumers. This suggested that 'compliance appears to be better in geographic areas in which it should be easier to compare one's utility to neighboring utilities with similar characteristics'.³³

How does benchmark competition lead to systemic improvement? In some cases, the results delivered by the independent provider are used by senior management to establish new performance standards for the remainder of the system. Lord Carter used HMP Blakenhurst's service level agreement (or rather its failure to meet those standards) as a tool for measuring what might be possible across the Prison Service as a whole. He was explicit about the difficulty that government faced when it lacked such a yardstick:

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Challenging the efficiency of public sector prisons is difficult, as a clear view of the desired output and outcomes of prisons is lacking as well as how much this should cost. Without this information, the government is not in a position to demand efficiencies from its prison providers.

... to continue the work at HMP Blakenhurst the government should begin a programme of cost and activity profiling across the public sector estate in order to define an efficient cost for each prison that takes into account how services can be provided most efficiently and makes choices about what services are provided.³⁴

In other cases, publication of the benchmark stimulates reform through embarrassment and/or political pressure from lobby groups and the public at large.

In some jurisdictions, competition and contracting have been deliberately used to pilot new approaches to service delivery, and the public sector client is thus eager to disseminate any lessons learned across the system as a whole. In our original submission we referred to several examples of 'cross-fertilisation' in the United States, the United Kingdom and Australia provided by Professor Richard Harding.

In other cases, it is the process of competition that causes innovation to spread. Where in-house providers compete with external providers, the need to cost individual activities, engage in process redesign and undertake the risk of introducing service innovations will provide lessons that can be disseminated across other parts of the organisation. One example was the introduction of activity-based costing by the in-house team when they competed (successfully) to provide street maintenance in Indianapolis. In this particular case, the reform process was studied not just by the city itself, but by the Harvard Business School, and it has become a case study to be pored over by public and private sector managers from around the world.³⁵

Where the process of competition is ongoing, then there will be an ongoing incentive to embrace the new ideas introduced by successful bidders. For the most part, governments do not permit private providers to own the intellectual property associated with service innovation, so that successful innovation spreads quickly. When a private sector consortium introduced the concept of robots into a new PFI hospital in Scotland, the idea was copied by other firms long before the facility was built and the robots were operational. In a competitive environment, public providers of public services will imitate new initiatives in this same way.

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Finally, there are specific cases where senior government officials and the directors of individual prisons have raised the threat of competition as leverage to encourage middle managers and staff to think differently about the way in which services might be delivered and make reform less threatening.

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9. *The Committee has heard that accountability mechanisms for privately managed prisons are lacking. How would you respond to this assertion?*

If done well, competition and contracting can result in greater transparency and accountability. The following passage from the June 2008 report of the Office the Inspector of Custodial Services into Acacia Prison in West Australia illustrates this claim well:

It is no coincidence that the best private prisons are usually found where strong accountability measures are in place. In Western Australia, Acacia undoubtedly sets the benchmark for transparency and accountability, and has leveraged better accountability throughout the prison system. Six aspects of this should be noted:

- Acacia (unlike other prisons) is subject to clearly set and monitored contractual requirements (including penalties for non-performance) on issues such as security, safety and the delivery of treatment programs, education and training.
- The contract, including these requirements, is publicly available.
- This office has conducted three formal inspections in the six and a half years of Acacia's existence, as well as keeping a strong eye on the prison through liaison visits and other activities.
- The Department of Corrective Services holds Acacia to account through its monitoring and contract management processes and through its annual reports to Parliament (other prisons are not subject to this level of scrutiny).
- Ultimately, AIMS [the previous contractor] were held to account in the strongest possible way when their contract was not renewed following the re-tendering process.
- This office, having been established against the background of privatisation, has brought greater scrutiny to the whole prison system.

It can safely be said that the expectations of the public sector prisons are less clear and less robustly monitored than Acacia's. Indeed, some of those prisons would almost certainly have been put out for re-tendering if they had been privately operated.³⁶

This view – that contracting usually results in increased accountability – is shared by public service managers who have worked under both regimes. In our original submission, we reported a qualitative and quantitative survey that the Institute had conducted with around 100 of Serco's contract directors who had previously managed similar services in the public sector. This study was enlightening since these were the same people delivering the same services, except under different management models.

As we reported in our submission, in response to the statement: 'Under contract, scrutiny is much closer and performance is much more visible than is experienced in similar public sector institutions', 38% strongly agreed and a further 51%

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agreed. Only 2% disagreed. Similar results were found for the statement: 'Managing my contract, accountability is much more personal than it was in the public sector – I feel I am under the spotlight to deliver' (34% and 50% agreeing, with 7% disagreeing).³⁷

However, contractual accountability differs in certain respects from traditional bureaucratic accountability. As we argued in the original submission, competition and contracting are built on the principles of performance accountability – specification of key performance indicators, ongoing monitoring of results, financial and reputational penalties for under-performance, and periodic rebidding (or formal benchmarking) of the service or activity.

Moreover, in the UK, each of the contract prisons has two or more public officials located at the prison full-time, monitoring and reporting on performance. With the exception of the two prisons that operate under service level agreements, none of the publicly-managed prisons is exposed to that amount of scrutiny.

As we noted in that document, HM Prison Service has used the performance accountability system developed for the contract prisons as the basis for its own internal 'Weighted Scorecard' (and that system is still in need of significant refinement).

There also tends to be much stricter financial accountability in contractual organisations. In Lord Carter's Review of Prisons (referred to above), the financial accounts for HMP Blakenhurst had become deficient over time, but Lord Carter was nevertheless able to use the original contractual documentation as a basis for benchmarking the financial management of that prison and, by extension, the rest of the prisons estate.

The evidence from the United Kingdom and Western Australia is quite clear – competition and contracting have substantially strengthened both performance accountability and financial accountability.

In many public services, the process of negotiating a contract with an external provider results in stricter regulatory accountability. It is difficult to research this issue, since contractors are usually reluctant to allow information to be published that might be construed as criticism of their government client. However, we are aware of numerous examples where public services were immune from independent safety and environmental regulation until management responsibility passed to an external provider under contract. In one case that we have studied, the transfer of certain physical assets had to be deferred because they lacked independent certification. Since they were subject to legal and regulatory disciplines, the contractor was not prepared to assume responsibility for those assets until formal certification had been obtained.

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Moreover, in the United Kingdom and in Western Australia, all prisons, public and private, are subject to scrutiny by an independent inspectorate, and in the UK by independent monitoring boards.

Many of the claims of an alleged decline in accountability seem to relate to the question of 'commercial-in-confidence', which is surprising since the information that this covers has never been collected, let alone requested about publicly-managed prisons. However, outside of the competitive process, the scope of commercial-in-confidence is quite narrow – in most cases, it would extend no further than profit margin and the allocation of staff to specific tasks.

In short, as long as competition and contracting are done well, we are of the view that it should result in significant greater transparency and accountability.

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9a. Do you believe that there is an inherent conflict between the broader goals of public accountability and the profit imperatives of a private sector provider?

No. The passage quoted above from the report of the WA Inspector of Custodial Services demonstrates that the management of prisons by a private contractor is fully compatible with enhanced public accountability.

Under public service contracting, profitability is dependent on the delivery of public services to a specified level of service. If they are done well, the contract (and the financial rewards and penalties associated with the performance targets) serve to align private interest and public duty.

And a concern for corporate reputation and the prospective new business that a good reputation may bring helps to ensure that companies do not take a short-term view of financial considerations.

We recognise that an obsessive focus on financial considerations can undermine a focus on the quality of service and social policy outcomes. However, this tension is by no means confined to the profit imperative; it can also be caused by an excessive focus on cost reductions by government.

Indeed, when the Serco Institute interviewed around one hundred contract managers (including a number of prison directors), only 8% reported that their capacity to deliver high quality services had often been compromised by the need to deliver profit, while 18% reported that it had been compromised by the need to deliver savings asked for by the government customer. (To our knowledge, no one has ever asked this question of public sector managers.)

In short, if it is done well, competition and contracting can be used to enhance service quality and public accountability. Conversely, an excessive focus on financial considerations by government or by a private contractor has the potential to compromise the same.

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- ² Gary L. Sturgess et al, 'Competitive Edge: Does Contestability Work?', London: The Serco Institute, 2007.
- ³ Industry Commission, 'Competitive Tendering and Contracting by Public Sector Agencies', Report No.48, Melbourne: Australian Government Publishing Service, January 1996, pp.10-13.
- ⁴ Paul H. Jenson and Robin E. Stonecash, 'The Efficiency of Public Sector Outsourcing Contracts: A Literature Review', Melbourne Institute Working Paper No.29/04, October 2004, p.9.
- ⁵ Graeme A. Hodge, *Privatization: An International Review of Performance*, Boulder, CO: Westview Press, 2000, pp. 128-129.
- ⁶ Gary L. Sturgess, 'Competition: A Catalyst for Change in the Prison Service', pp.14-18; Gary L. Sturgess et al, 'Competitive Edge: Does Contestability Work?', pp.40-41.
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- ¹⁰ See, for example, Richard Wener, 'The Invention of Direct Supervision', *Corrections Compendium*, March-April 2005, pp.4-7, 32-34.
- ¹¹ Alison Liebling, *Prisons and their Moral Performance: A Study of Values, Quality, and Prison Life*, Oxford University Press, 2004.
- ¹² Gary L. Sturgess et al., *Competitive Edge: The Evidence*, London: The Serco Institute, 2008, p.79.
- ¹³ Lord Carter of Coles, 'Securing the Future: Proposals for the Efficient and Sustainable Use of Custody in England and Wales', December 2007, pp.22, 36, 46, at <http://webarchive.nationalarchives.gov.uk/+http://www.justice.gov.uk/docs/securing-the-future.pdf>
- ¹⁴ Scott D. Camp and Gerald G. Gaes, 'Private Adult prisons: What Do We Really Know and Why Don't We Know More?', in David Shichor and Michael J. Gilbert (eds.), *Privatization in Criminal Justice*, Cincinnati, OH: Anderson Publishing Co., 2001, pp.283-298, at pp.290, 294. See also Julianne Nelson, 'Competition in Corrections: Comparing Public and Private Sector Operations', Revised Version, Alexandria, VA: The CNA Corporation, December 2005, pp.8 & 63.
- ¹⁵ See Gary L. Sturgess et al, *Competitive Edge: Does Contestability Work?*, London: The Serco Institute, 2007, p.67.
- ¹⁶ Public Accounts Committee, 'Value for Money from NSW Correctional Centres', Report No.13/53 (No.156), Sydney: Legislative Assembly of New South Wales, September 2005.
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- ¹⁸ See, for example, James G. March, 'Exploration and Exploitation in Organizational Learning', *Organizational Science* (February 1991), Vol2, No.1, pp.71-87, at p.79.
- ¹⁹ These conclusions are based on a forthcoming study by the Serco Institute of the origins of the prisons market in the UK in the late 1980s and early 1990s, based on interviews with those involved at the time.
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²⁴ Jon Scott, 'Prison Breakthrough', *Business Voice*, October 2007, pp.42-48.

²⁵ For a succession of criticisms of this interference in the prison system, see Gary L. Sturgess, 'Competition: A Catalyst for Change in the Prison Service', London: Confederation of British Industry, July 2003, pp.32-33.

²⁶ Emma Reddington, 'Good People, Good Systems', p.29.

²⁷ Emma Reddington, 'Good People, Good Systems', pp.34-35.

²⁸ For a discussion of some of these issues, see Charles H. Logan and Bill W. McGriff, 'Comparing Costs of Public and Private Prisons: A Case Study', *National Institute of Justice Reports*, 216 1989, p.2.

²⁹ Lord Carter of Coles, 'Securing the Future', December 2007, p.36.

³⁰ Coopers and Lybrand, 'Review of Comparative Costs and Performance of Privately and Publicly Operated Prisons', London: HM Prison Service, June 1996; Isabelle Park, 'Review of Comparative Costs and Performance of Privately and Publicly Operated Prisons, 1998-99', *Home Office Statistical Bulletin*, Issue 6/00, London: Home Office, 23 March 2000.

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³⁵ Robert S. Kaplan, 'Indianapolis: Activity-Based Costing of City Services', Case Study 9-196-115 and 9-196-117, Harvard Business School, 1996 and 2003.

³⁶ Office of the Inspector of Custodial Services, 'Report of an Announced Inspection of Acacia Prison', Report No.53, Perth, Western Australia, June 2008, p.10. at

<http://www.custodialinspector.wa.gov.au/download.cfm?downloadfile=71D3A5C6-E7F2-2F96-343AF922D1E46193>

³⁷ Emma Reddington, 'Good People, Good Systems: What Public Service Managers Say', pp.5, 7.