

SERVICE DELIVERY

Looking at Strategic Options

The purpose of local government is—

- (a) to enable democratic local decision-making and action by, and on behalf of, communities; and*
- (b) to promote the social, economic, environmental, and cultural well-being of communities, in the present and for the future.*

Section 10
Local Government Act 2002

1. Introduction

Community assets have seen considerable change over the last 150 years.

During the late 19th and the first part of the 20th centuries, there was a realisation that communities have a vested interest in infrastructure assets which serve community needs. The needs were not necessarily going to be met by the private owners who originally developed, owned and operated those assets. More in the United Kingdom than here, strategic assets were compulsorily acquired in the public good to ensure that they were, and continued to be available to serve the communities which had become dependent on them.

In the years that followed, those assets were further developed and maintained from the public purse. Typically, large bureaucracies were formed, with local government taking on the capital investment, maintenance, operation and repair functions.

In New Zealand, central government owned and controlled a number of services, including the national postal system, the telephone system, broadcasting, energy generation and the rail system, airlines and shipping.

Local government provided our water, dealt with wastewater and storm water and rubbish collection, provided parks and recreation, health services, owned and operated the ports and airports and provided local public transportation.

Ideological changes in the 1980s saw the sale of non-core assets by both central and local government. The main drivers for this were given as accessing private capital and management expertise.

With the change in political perspective in the late 1990s and early into this century, there has been a growing realisation that maintaining the provision of services, rather than ownership, is the key issue. A critical part of this is an identification of the core business of

local government, and rational, rather than ideological, drivers for contracting out service delivery and asset management.

What we are going to look at is the rationale for contracting out asset management, ensuring service delivery, the role of local government under the new Local Government Act 2002 and, time permitting, a brief look at public-private-partnerships (PPPs).

2. **Contracting Out Asset Management**

Typically the structure of contracting out will be dictated by the reasons for it. At least, they should be.

There are a number of drivers which should be considered:

(1) *the core business of the local authority*

This is not just a question of efficiencies, but also of recognising the strengths of the business unit, and its core values. For example, if a water business has a poorly performing wastewater unit, then contracting out will be no substitution for addressing the problems within that unit.

Conversely, a broadband fibre optic network installed as part of the development of an electricity network may be nothing more than a distraction, regardless of how successful it is. In that scenario, that part of the business unit could be sold, and the limited services required by the business unit (eg, SCADA) could be contracted back. This would release capital to concentrate on core businesses, and hopefully provide the efficiencies of a business committed to running a broadband network.

(2) *the nature of the activity to be contracted out*

Clearly, some activities are more suited to contracting out than others. One issue that is frequently overlooked is that contracting out is rarely about the provision of a new service. Usually, contracting out involves the discontinuance of existing jobs, and the relocation of staff. Not something to be done lightly

If a business unit is to be corporatised then sold, and services are then to be contracted back, there will also be an element of capture by both parties. The sold business will have the institutional memory of the local authority, and the local authority will inevitably be the biggest source of work for that business for some time.

If there is no reasonable prospect of testing price and service delivery against competing businesses, then the rationale for contracting out in the first place may not have been well considered. Similarly, if the divested business unit has no reasonable prospect of standing on its own feet and finding other sources of income, then the likelihood of service needs being met is slim.

(3) *the service delivery sought by the local authority*

This may be wider or narrower than the competencies available, but service delivery should be well defined. If it is outside the local authorities core activities (eg in IT support), but the needs are infrequent, and highly specialised, then the business unit may be best suited to expanding beyond the local authority, and the local authority may get better, more specialised service more cost effectively.

(4) *what the private sector is to bring*

This can be provision of specialised expertise, capital and management skills or simply freeing capital and management time within the local authority.

The need for contracting out has to be driven by more than current fads, like PPPs.

Private sector investment can be driven by an innate belief in efficiency, constraints on funding, available capital and/or ideological belief. By giving a private sector partner a vested interest in the outcome (successful or otherwise), and involvement in operations and management decisions, the principal advantage of PPPs in their many forms is to create synergies.

If there is no net benefit to the community, then it can be a rather pointless and expensive exercise.

For the purposes of this paper, I have assumed that operation of the asset and the customer interface is retained by the local authority.

So, in the example of water services, the local authority procures the water (either by purchase from a bulk water supplier or through its own treatment process) and reticulates it to the householder. The water network is owned by the local authority, and the local authority also has the contractual relationship with the householder. The network maintenance contractor has a performance based contract with the local authority and, while work may be undertaken at the request of the customer and on private land, the relationship with the customer remains with the local authority.

Conversely, it is also possible for the entire service delivery (ie, provision of water) to be contracted out and the assets sold or leased, subject to legislative constraints. The contractor undertakes, for example, to provide potable water to all households within a geographical area and to handle all new connections, network upgrades and repairs and maintenance. This has benefits, but requires more careful consideration of allocation of risk, monitoring performance and political management at both local and national levels.

3. Service Delivery

Once the rationale for contracting out has been established, and assuming that contracting out remains the best option for promoting the core activities of the local authority, then the services should be capable of definition.

Where an existing business unit is to be sold and the services contracted back, most sales contracts will contain some level of assurance about continued business for a period to protect the goodwill of the business unit. Similarly, the local authority may retain a shareholding in the business sold. The immediate benefits of testing price and performance against the market will not become immediately apparent. Care also needs to be taken to ensure that such exclusivity arrangements do not offend the anti-competitive provisions of the Commerce Act.

Defining the services and establishing a payment regime should be relatively easy to agree, either by direct negotiation or by tender or other contested process.

Dealing with variable performance levels and quality issues is sometimes less easy to legislate for. There are a number of ways of addressing this:

(1) *Fixing financial adjustment to performance*

As a general principle of law, withholding or reducing payments arbitrarily for breach of contract, unrelated in monetary terms to the amount withheld, is unenforceable as a penalty.

However, to precondition entitlement to payment to performance of particular contractual obligations is not. For example, if the provision of monthly data and performance information is important to you, and irritating and inconvenient if it is not provided, but has no monetary impact on you, it is hard to set a financial penalty for non-performance. Imply withholding payment would certainly be a penalty. However, it is entirely enforceable to provide that the contractor cannot make a claim for payment, and such a claim will not be considered, until performance reports have been provided in accordance with the contract.

Similarly, most performance related contracts have provision for a percentage of the payments to be adjusted based on achievement of key performance indicators (KPI).

Those KPIs, to have any meaning, must be measurable and must be inextricably linked to provision of the service. In the broadband example, the network operator's payment could be assessed by response times to complaints, outages and network stability. The key is to ensure that the KPIs are relevant, measurable and objective.

KPIs which are vague, uncertain and rest solely in the subjective judgement of the client are harder to justify and can be very damaging to the relationship between the

parties, which is arguably one of the keys to the success of contracting out asset management.

(2) *Linking expansion of the services and renewals to performance*

Where a KPI procedure has been implemented, its application can be extended to cover variation of the scope of the services and the contract term.

For extensive contracting out, the relationship between the service provider and the client local authority becomes key. If the relationship works well, then there may be grounds for extending the size of the network, the services or other assets which are managed, or extending the term.

Conversely, where a contractor does not perform, the KPI procedure can provide an opportunity to reduce the scope of work.

(3) *Redefining remedies for default*

The difficulty with many large capital contracts and relationship contracts is the failure of the contract to provide a remedy for default, short of terminating the contract. Similarly, the contractor's performance may be woeful in a large number of areas which cause real grief to the client council, but may not be sufficient to trigger termination.

In this scenario, allocating demerit points to key areas, and using the demerits to reduce the scope of the services, shorten the term and/or terminate the contract once agreed thresholds have been passed is a very effective tool. Most contractors become very focussed on service qualities (or contract terms and conditions) once demerit points have been allocated.

Like KPIs, demerit points must also be relevant, objective and measurable. A few carefully set performance measures is also typically more effective than a large number of broad, poorly focussed and subjective measures. All too often, those of us who advise in this area see lengthy clauses which are very hard to apply, and which have little real impact. I suspect this reflects a lack of clarity between the parties on what is intended, and of course in the minds of the drafters.

On a general note, obscure, incomplete and muddled drafting is frequently a major cause of subsequent misunderstanding and dispute between parties to long term contracts. Generally it is worth taking the time to work through difficult issues. If it goes to dispute, the time and cost involved in getting contractual provisions right in the first place will pale into insignificance.

4. Role of Local Government

There is a distinction to be made between a local authority's regulatory role (eg as a consenting or enforcement authority) and its other activities, where it is participating in normal commercial activities (eg as stadium owner, transport provider, event organizer, property developer or water network owner). It is this second role that is of particular interest to us as, in most cases, the regulatory role is not one which can be contracted out.

As mentioned above, an early consideration of any contracting of asset management, whether for a new service, divesting a sector of business or a new PPP, must be to determine the core business and the benefits to be captured by contracting externally rather than doing the work in-house. This should include a clear understanding of the role of local government.

The purpose of local government is set out in section 10 of the LGA 2002, which is quoted at the start of this paper. The role of local government is to give effect to that purpose (see *section 11 of the LGA 2002*).

In performing its operational functions:

- (1) *A local authority is a body corporate with perpetual succession.*
- (2) *For the purposes of performing its role, a local authority has—*
 - (a) *full capacity to carry on or undertake any activity or business, do any act, or enter into any transaction; and*
 - (b) *for the purposes of paragraph (a), full rights, powers, and privileges.*

...

Section 12 LGA 2002

This is a significant change from the LGA 1974, removing one of the main planks of the doctrine of *ultra vires*, namely that a local government body can only do what it is specifically authorised by statute to do. Local authorities now hold what is called a power of general competence, meaning in effect that they can do anything which is not specifically proscribed.

The new Local Government Act is a major departure from the previous Act. There are increased levels of consultation, more complex and overarching procedures for planning and greater focus on accountability.

LATEs are a thing of the past, with Council Organisations, Council Controlled Organisations and Council Controlled Trading Organisations, in their stead.

The Act also deals with, and constrains the divesting of, local authority water businesses in some detail. Under s 102(4)(e), as part of its long-term council community plan (LTCCP),

councils are to develop a policy on partnerships with the private sector. Section 107 sets out in more detail the matters to be covered in this policy, including:

- policies on the commitment of local authority resources to the partnership
- circumstances in which the local authority will provide funding
- consultation on the level of funding
- conditions attaching to the funding
- outline of risk assessment and management
- procedures for monitoring and reporting
- assessment of achievement of community outcomes.

Part 7, SubPart 2 of the LGA deals in some detail with water services, and the restricted circumstances under which water services can be contracted out. Local authorities' constraints in relation to their water business units, set out in s 130, are:

- (a) not to use assets of its water services as security for any purpose
- (b) not to divest its ownership or other interest in a water service except to another local government organisation
- (c) not to lose control of, sell, or otherwise dispose of, the significant infrastructure necessary for providing water services in its region or district, unless, in doing so, it retains its capacity to meet its obligations
- (d) not to stop or restrict water supply except in restricted circumstances.

The terms upon which water services can be contracted out, and partnerships formed, are set out in more detail in ss 136 and 137.

- The term of the contract must not exceed 15 years
- The local government organisation must retain control over pricing, management and delivery
- Partnerships must be established following consultation, and provide for continued ownership of all assets by the local government organisation

This provides limited scope for PPPs in the traditional sense.

5. **Public Private Partnerships**

In most seminars and writings on PPPs, a bewildering maze of flowcharts is presented, showing how large and complex the relationships are (and by extension the documentation

required). The consistent thread in each approach, however, regardless of the initials used (whether DBO, DBFO, BTO, BOO, BOT or BOOT), is the appointment of the private sector to develop, operate, maintain and usually, though not necessarily to own, assets traditionally held in the public domain. This has developed over the last 10 years or so to include the provision of the services themselves.

Under the UK model, typically the private sector contracts with the public sector to provide at its own cost:

- All necessary assets (whether a new prison, hospital, school or road)
- Staff for operation and maintenance of the service
- The provision of the service to agreed levels

This may include the transfer of an existing asset from the government body to the private sector, the grant of associated rights and for the private sector to fund the acquisition, development and operation entirely at its own cost. Generally, the term of the appointment is in the region of 30 years, and if the funding is available, more.

The funding cost is then covered either directly by users (eg through tolls or other use based charges) or by the public sector itself (eg through shadow tolls) or a combination of both. Some form of guarantee for cashflow purposes is also typically given by the public sector.

Why PPP

Over the last 10 years or so, under the broad heading of PFI/PPP, more than 450 major projects have been let in the United Kingdom, representing over £20 billion in private investment in the public sector.

The views on the success of PFI/PPP in the UK are mixed. On the plus side:

- Private sector efficiencies have been delivered (principally in the cost of providing the services)
- Service levels have been maintained or improved, depending on the industry
- Good returns have been provided for investors

On the negative:

- Concluding the early transactions was time consuming and difficult, with perceptions that the only beneficiaries were the lawyers and investment bankers who negotiated the deals
- PR for the early projects were not good, with a perception that service levels were not being improved, assets not maintained and the private sector was making a

runaway return (one project resulted in a 39% return, with only 5% equity commitment)

- The experience of rail, with the separation of track from operations and the perceived difficulties with the London Underground project, have not been shining examples of the private model

Ultimately, whether fuelled by an enduring belief that the private sector can deliver efficiencies that the public sector cannot or by the strength of the capital markets and the construction industry being such that it can promote such projects itself, the model has enjoyed significant success in the UK. Through standardisation of contracts, deal costs and delays have been reduced to the extent that the model is now being used for more modest projects which can deliver real benefit to the community.

A substantial capital market has developed with an appetite for long term debt (some bonds exceeding 35 years) and the perception that unjustified returns are being made has been addressed by providing for a sharing mechanism on savings in funding costs (effectively more risk sharing).

Drivers for the success in the UK were:

- A belief (at time during the Thatcher years bordering on doctrinaire) that those in the private sector are better managers than their equivalents in the public sector
- Constraints on central and local government spending, making “off balance sheet” developments more attractive
- Available capital, principally through contractors
- A strong capital market, with a significant appetite for long term investment

PPP Elsewhere

Similar privately funded infrastructure approaches have been looked at in Germany (hire-purchase, lease and renting projects) and elsewhere in Europe, Japan and in Australia. BOT projects have been the mainstay of tunnel, bridge and roading construction and operation in Hong Kong, and are seen as a source of capital for other Asian nations which were once seen as developing.

In Australia, private funding has been used to restructure existing assets and for the development of new ones. In Victoria, the success of the privatisation programme has encouraged the State Government to develop a policy framework called *Partnership Victoria* to assist with and promote infrastructure development.

In New Zealand, PFI/PPP models were considered for Wellington and Auckland hospital redevelopments, but abandoned. There is a growing acceptance, however, of the benefits of contracting out asset management functions at local government level, and that public

services do not necessarily need to be provided from publicly owned assets, though there is a lingering concern about service levels.

Similarly, while we do not currently enjoy access to the long term capital markets which have established in the UK, there is interest in New Zealand in long term, gilt edged funding which projects like these can provide, particularly when backed by appropriate guarantees. Some privately funded developments have been completed here on a limited recourse basis (eg the Wellington and Hutt Valley waste water treatment projects and the Mokai geothermal project), and there is growing interest.

The form of any large scale PPP developments here is likely to be determined by need. In contrast to the UK:

- We do not have the constraints on borrowing which have held back local government in the UK (though legislative change will be required in some industries)
- Generally traditional debt equity is available to local authorities (typically through CCTOs, formerly LATES) more cheaply than would be available through the more complex approach taken by PPPs
- Our contractors are characterised by poor capitalisation compared to Europe, Australia and the US, though alternative sources of equity would almost certainly be found

There is a real need, however, for infrastructure development in New Zealand, and we have the benefit of considerable work in the UK and Australia. Presented as an opportunity to develop assets which would otherwise not be available, public reluctance to pay tolls and other user charges may fade; particularly if the assets are seen as held locally through investment funds.

The drivers here are likely to be:

- Need for the development of new infrastructure due to initially poorly developed assets and lack of proper maintenance and provision for growth
- Public desire for first world infrastructure development and efficiencies
- Lack of government will to develop the assets through traditional debt (appetite for increased taxes is limited, and concern over inflationary pressures means that budget deficits are things of the past)
- Shortage of local capital, and concerns over foreign ownership
- Public wariness over perceived asset sales without real long term benefit
- Increased desire to see the concept of “service” returned to the public sector, rather than hard nose private sector commercial drivers

In this context, our version of the PPP model will be an interesting departure from those followed elsewhere. We can, however, certainly benefit from their experiences. It is unlikely, in the roading sector, that the Land Transport Management Bill, if it is passed into law, will achieve any such gains. I for one cannot see a single project getting off the ground with the current proposal.

6. **Conclusion**

Whatever contractual structure is adopted, the key issues are:

- to properly identify the role of the local authority
- to realistically define the expertise and scope of the service of the private sector
- set in place contractual procedures which promote a productive and mutually beneficial relationship
- provide a structure which gives all parties a vested interest in a positive outcome, whatever that may be for the project.

If these are achieved, regardless of the name given to the contract, it will be successful.