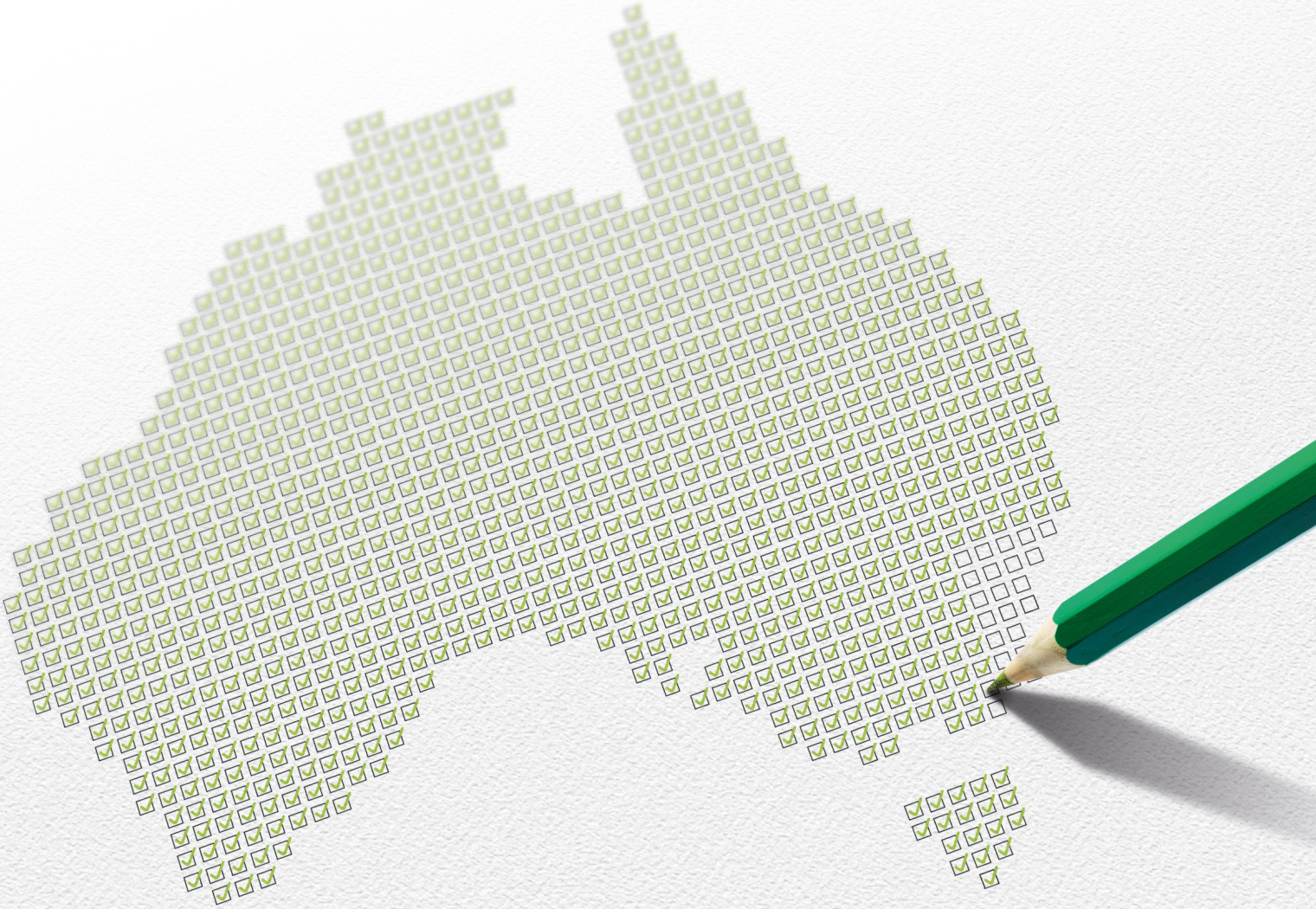
Deloitte.

# Contestability
## A new era in service delivery reform



# Contents

# A new era in service delivery reform

The commissions of audit at a Federal and State level point to a need for reduction in expenditure and urgent reform in the way services are delivered, planned and funded. As available funds shrink, the allocation of these scarce resources becomes increasingly critical to the balance of fiscal and social responsibilities of government.

Globally, public sector reform is grappling with the same challenge and a myriad of different concepts are emerging in the lexicon of the public sector. The terms and phrases often associated with contestability now include:

- Payment by results
- Commissioning
- Outsourcing
- Franchising
- Social reform
- Social impact bonds.

All of these terms can relate to contestability, but they should not be confused with contestability itself.

### Contestability is about people, not funding or assets

A common misconception around contestability is that it is about cost savings. While cost reduction is a key desired outcome of contestability and service delivery reform, it is only one component. Of primary importance are the results of improved services for customers and users, and the long term sustainability of those services.

At the core of contestability is the idea that services, and the assets that support them, exist to help people and society. While the process of contestability is usually a transaction, the final outcome must always be couched with empathy for the end user and a strong grasp of the service the government is seeking to provide.

### Underlying objectives

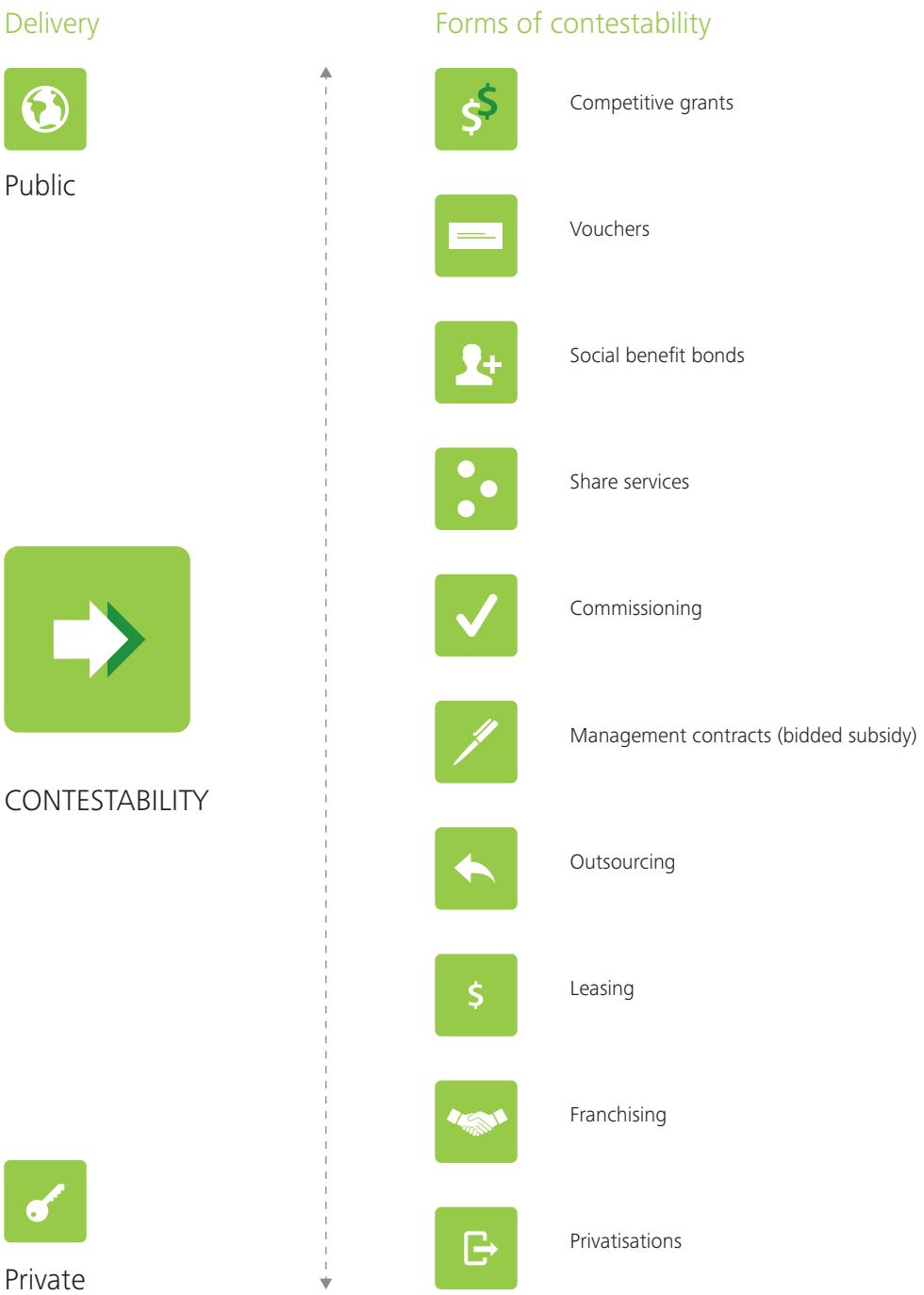
Unpacking the jargon can be a long and tedious process. A helpful starting point is determining the underlying objectives (aside from improved value for money) for investigating alternate delivery and funding options.

It is important to note that these options do not necessarily involve shifting delivery to the private sector, but can include introducing competitive forces. For example, government vouchers provide a non-private funding option. These could include:

- Doing more for less – improved productivity
- Raising service or other standards
- Cost savings
- Innovation
- Competition and choice.

Additionally, understanding which of the underlying objectives is at play, combined with comprehension of what is driving the competition in the service or other delivery, will help clarify which option in the below illustrative continuum would be best to explore. That is, is it the consumer who is driving increased value through better service delivery or is it the market itself?

Figure 1: Service delivery continuum



# Terminology

Empathy for the customer must underpin the design and selection of a model for funding and delivery of sustainability of services.

Below is a brief 'cheat sheet' on terminology:

| Terminology | Definition |
|---|---|
| Payment by results | Links the funding envelope to the providers (public or private) and to a delivery outcome. |
| Commissioning | This is carried out before procurement, it frames the question and approach to delivering better service outcomes by examining the delivery of services from private, public or not-for-profit organisations to better harness the benefits of competition. |
| Outsourcing | This is contracting out a business or service to a third party. Often this refers to non-client facing activities such as payroll or IT; the service that enables service delivery reform but not the services themselves. |
| Franchising | In a franchising model, the government generally retains ownership of the assets (particularly for rail) and the major policy levers (i.e. fares, routes and service standards), while the private sector provides management expertise and innovation. |
| Social Impact Bonds | A financing instrument whereby third parties, often philanthropists, offer a financing tranche upon certain outcomes being achieved. |

Again, it is important to recognise when selecting or assessing alternate options, that the focus comes back, and is firmly grounded in, improving service outcomes for customers and users.

# Key challenges and implications

We have identified some possible challenges or issues and their implications when navigating the contestability lexicon to help prioritise the most appropriate option(s), whilst ensuring a central focus remains on the client experience and outcomes.

| Key challenge impacting value for money and user outcomes | Considerations and mitigants |
|---|---|
| **Bidder education** | Providing bidders with the right information will reduce their bid costs and risk premiums, speed up the process, and reduce intrusion into the operating activities of current delivery 'modes', and therefore ensure continued customer service delivery. |
| **Correct bundling and packaging of services** | The methodology used to package services and assets for market will be a key driver of value and will send important signals to the market, including information about customer standards and expectations. |
| **Data quality of current operations and assets** | Poor quality data on operations and assets may result in a risk premium from the private sector and eroding value to the government, and ultimately service quality to the end users via quality or increased costs. |
| **Probity and process** | Many contestable processes will be highly sensitive and therefore must be managed in a probity aware environment. Contemporary best practice uses an interactive method to ensure engagement and exchange of ideas throughout the process. This reduces negotiation and evaluation time and ultimately provides a better value for money outcome. |
| **Barriers to entry** | Barriers to entry can prevent contestability for new providers and result in a monopoly position for incumbents. Reducing barriers to entry for a first generation contract is important. Reducing barriers to entry for a subsequent operator is essential to ensuring ongoing contestability. |

| Key challenge impacting value for money and user outcomes | Considerations and mitigants |
|---|---|
| **Financial viability and credibility of the new operators/providers** | Governments will always retain some risk and responsibility for providing essential services, even in strict privatisation the legislation and policy risk remains. So, it is critical that capable service providers are engaged (e.g. track record of safety and quality) under financially sustainable arrangements. This will require robust market and provider due diligence. |
| **Market capability and contestability** | The capability and future contestability within the market are important policy, user and value for money considerations. It is possible that the likely bidders for a particular service, particularly subsidised management contracts, are Not for Profit providers (NFPs), as well as corporate providers. When examining market capability and capacity it is important to look at 'adjacent' service providers, i.e. providers who may not offer the exact service but have the resources, processes and customer experience to deliver the services. This is especially true if there is minimal investment required in the supporting infrastructure. |
| **Managing demand growth** | In understanding clear or latent demand in a particular service, the government needs to be realistic, including around the limited tools at their disposal to manage this growth. They must also have the courage to speak the truth to power in the privacy of ministerial offices, if not in the 'public domain'. The government needs to be cognizant of this implication when setting the commercial principles of the deal.<br><br>The allocation of future and latent demand risk will be an important factor in delivering value for a contestable process, ensuring the needs of future clients are met. |
| **Concession term/contract term** | The length of a contract or concession term will be an important part of achieving value for money. A term that is too short may see a failure to invest, while a term that is too long may see a failure to innovate and adjust to changing user requirements. |

| Key challenge impacting value for money and user outcomes | Considerations and mitigants |
|---|---|
| **Payment mechanism and KPIs** | The payment mechanism for ongoing services must balance the funding constraints and the desired outcomes. Overly prescriptive KPI regimes can result in operators or providers 'gaming' results or in the worst case scenario, handing back the contract due to non-performance and abatement. There must be clear incentives to deliver on customer and user outcomes. We work on the principle that the KPI regime should be outcomes focussed and limited to a small number of core KPIs. The temptation is to seek to measure causal factors of failure when an output based measure is the real objective. For example, there may be a temptation to seek to monitor maintenance when the overall objective is actually availability. If the maintenance is not being carried out then the availability will suffer. A small number of transparent, measurable and meaningful KPIs will drive the correct provider behaviour. |
| **Innovation funding mechanisms** | When scoping a process it can be helpful to examine alternative funding models, such as Social Impact Bonds. Because there are often significant social outcomes associated with the process, it may lend itself to these payments by results mechanisms. |
| **Staff transfer considerations** | • Some existing employees may be part of a government's Defined Benefits Scheme<br>• A redundancy program can result in significant short term costs and change management impacts<br>• Any transition and protection of staff entitlements must be carefully managed. If entitlements are likely to be transferred, consideration should be given to an amortising security or insurance bond to protect them. Alternatively, governments may consider keeping the entitlements on the balance sheet and drawing on them as and when they are used, until a nil balance is reached<br>• As packages are developed, timing of expiring enterprise bargaining agreements (EBAs) must be considered, to ensure a smooth transition. |
| **Asset condition and remedial maintenance** | In the case of heavily asset dependent services, asset condition and their remedial maintenance profile will significantly impact asset value. This must be taken into account when determining where the best outcome (not just value for money) could be obtained on the spectrum of options. For example, it may make sense to keep an ageing asset and have a provider lease a new one. |

| Key challenge impacting value for money and user outcomes | Considerations and mitigants |
|---|---|
| **Asset valuation, stranding and alternative use or transfer** | In the case of heavily asset dependent services, the asset valuation and transfer mechanism will affect sale proceeds and the government balance sheet. |
| **Credit rating impacts for the State** | The transfer, sale or lease of assets and services may have an impact on the state balance sheet and ultimately the credit rating. Significant issues to consider in weighing up which contestability option is best include:<br>• Whether any newly-created assets, and associated liabilities, should be recognised on the public sector balance sheet and in what form<br>• If the sale of assets will have any impact on the balance sheet. This can be managed to ensure assets are sold for at least their current book value. |
| **Indirect taxes** | Indirect taxes such as GST and stamp duty need to be considered in the contestability strategy. |

# Conclusion

At a time when governments are looking for alternate service delivery models, there has arisen a myriad of 'contestability' terms and nomenclature which has caused confusion around the understanding of contestability.

Delving into the principal drivers or objectives for pursuing contestability (aside from the cost drivers as set out in the commissions of audit overarching findings and recommendations), combined with a researched understanding of what is behind competition in the delivery of a service, will help government best meet their clients' needs in the most cost efficient manner.

# Contacts

**Luke Houghton**
National Lead Partner
Transport, Infrastructure
& Contestability
Tel: +61 2 9322 5245
lhoughton@deloitte.com.au

**Andrew Johnstone-Burt**
National Leader
Public Sector
Tel: +61 2 9322 7525
ajohnstoneburt@deloitte.com.au

**Ken Sargison**
Partner
Human Capital
Tel: +61 7 3308 7204
kesargison@deloitte.com.au

**Tim Arbuckle**
Partner
Infrastructure Advisory
& Contestability
Tel: +61 3 9671 7511
tarbuckle@deloitte.com.au

**Fran Thorn**
Partner
Public Sector
Tel: +61 3 9671 8320
fthorn@deloitte.com.au

**Luke Baxby**
Partner
Life Sciences and Health Care
Tel: +61 7 3308 7202
lbaxby@deloitte.com.au

**Luke Parsons**
Partner
Infrastructure Advisory
& Contestability
Tel: +61 8 9365 7380
lparsons@deloitte.com.au

**Adrian O'Dea**
Partner
Infrastructure Advisory
& Business Modelling
Tel: +61 8 8407 7143
aodea@deloitte.com.au

**Theo Psychogios**
Partner
Infrastructure Advisory
& Contestability
Tel: +61 2 6175 2069
tpsychogios@deloitte.com.au

**Ross Alexander**
Principal
Infrastructure Advisory & Contestability
Tel: +61 3 9671 6085
rossalexander@deloitte.com.au

MCBD_HYD_01/15_0460123