PRIVATE DELIVERY OF PUBLIC SERVICES:
PUBLIC PRIVATE PARTNERSHIPS AND CONTRACTING-OUT

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Research Paper #21
June 2003
This version: January 2004

I am indebted to Michael Trebilcock for providing insightful and constructive comments on earlier drafts of the paper.
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1. Introduction

Governments routinely speak of returning to “core” activities and delivering “value for money” to taxpayers. Commentators write that the government needs to “reinvent” itself and to switch from a “rowing” to a “steering” capacity.¹ Most of the discussion has been focused on how government should react to the increased fiscal constraints that many jurisdictions have experienced in recent years.

For a significant portion of the 20th century, it was taken for granted that the existence of market imperfections implied that the state was the only credible provider for many services, such as health care, education, and prison operation. However, the past 20 years have ushered in a new era with respect to the delivery of public services. Citizens have witnessed the delivery of many services provided by the government being transferred to the private sector.² In most cases, the government continues to regulate and fund these services. These new private providers have come from both the for- and non-profit sectors. These relationships necessitate a yielding of at least partial control over delivery of public services from the government to the private sector; some argue that private delivery arrangements may comprise public values while others argue that public values may be strengthened.³

This paper examines two types of relationships that the private sector and government engage in: contracting-out and public-private partnerships (PPPs).⁴ This paper will define these relationships, and review the issues and theory underlying private sector delivery of public services. Specifically, the subjects of study will be the economic rationales motivating new delivery methods, the issues involved in structuring these arrangements, the process of project selection and implementation, partner selection, accountability, and the institutional implications

that arise. An examination of the policies and projects that jurisdictions have implemented, with a focus on Ontario, will be conducted.

Ultimately, structuring these arrangements successfully requires more than a “business-like” or “bottom-line” approach by government. Many pitfalls can beset the development of private sector delivery arrangements. The gains available from private sector involvement do not accrue from the simple action of involving the private sector. An integrated and robust accountability and evaluation framework in place throughout the entire procurement process, from project identification to implementation, is required to maximize the gains from private sector delivery. The breakdown or absence of such mechanisms can lead to losses that more than offset any expected benefits. Strong oversight mechanisms are also required to gain political acceptability. The government must be able to demonstrate to the public that private sector service delivery arrangements yield real benefits over traditional delivery methods.

2. Definitions and Attributes of Public-Private Partnerships and Contracting-Out

The language used in much of the literature regarding private sector delivery arrangements is imprecise. In many instances, the terms “contracting-out” and PPP are used interchangeably with “privatization” to describe any type of government initiative involving the private sector. Inaccurate language can lead to confusion regarding the true nature of the relationship between the parties.

PPPs and contracting-out are found on a continuum of possible service delivery arrangements. The extremes of the continuum are direct government delivery and privatization. Since Ontario is the area of focus, the definitions used in this province will be utilized. Direct delivery is defined by the Ontario Public Sector Restructuring Secretariat (OPSRS) as occurring when “[g]overnment delivers the service directly through its ministries, through business planning, focusing on results, cost recovery, getting the best value for the tax dollar, and customer service.”

Examples of direct delivery include income tax collection and the judicial system. In contrast, privatization arises when “[g]overnment sells its assets or its controlling

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interest in a service to a private sector company, but may protect the public interest through legislation and regulation.\(^6\)

Contracting-out, also referred to as outsourcing, is defined as taking place when “[g]overnment purchases services under contract from a private firm but retains accountability for the service.”\(^7\) Outsourcing arrangements can take many forms such as: franchise, service, management, or licensing contracts.\(^8\) In the past, governments commonly contracted-out inputs for services, such as building construction, maintenance, and cleaning. At present, the final delivery of functions, such as various social services and highway maintenance, are contracted-out.

Lastly, partnership is defined as occurring when “[g]overnment enters into a formal agreement to provide services in partnership with [other] parties where each contributes resources and shares the risks and rewards.”\(^9\) A PPP exists when the other party or parties belong to the private for- or non-profit sector. The definition implies that a PPP involves the pooling of financial resources between the public and private sector.

Ultimately, the choice to engage in these different types of relationships will depend on the government’s preferences regarding payment and control. On the continuum between direct government delivery and privatization, contracting-out lies closer to direct delivery, while PPPs lie closer to privatization. To illustrate: any project, whether it is a service, such as garbage disposal, or physical infrastructure, such as a bridge, includes a number of the following components: design, construction, financing, operation, and maintenance. For the purposes of this paper, an outsourcing arrangement involves an agreement between the public and private sector to carry-out at least one of these tasks, but does not include private sector financing (i.e., there is no private sector ownership). Hence, contracting-out is primarily a cost savings and service improvement exercise.

In contrast, a PPP will involve a series of these tasks and must include private sector financing (i.e., some degree of private ownership). Financial contributions and responsibilities constitute the sharing of risks and rewards within a PPP. Such situations will entail intensive

\(^{7}\) Ibid.
cooperation between the parties involved to ensure that responsibilities and expectations are clearly established and agreed upon.

In both cases, the expectation for a for-profit partner is a competitive return on its investment. The government and public have a number of expectations, including improved infrastructure quality, the more timely creation of new infrastructure, and cost efficiency.

However, the involvement of private financing in service delivery implies that PPPs are more than mere instruments of service delivery. They require partnerships in the design of public policy. Alternatively, contracting-out will generally occur with respect to a very specific aspect or stage of a project where the desired outcome can be clearly articulated by the government with limited private sector input. Therefore, in the case of PPPs, the ramifications of private sector involvement reach further than basic pecuniary costs and benefits, but may also involve trade-offs with respect to the control government wields over service delivery.

Ideally, governments will use contracting-out and PPPs to improve public service delivery by taking advantage of private sector expertise and efficiencies. These arrangements should be designed to allocate risks and responsibilities between the public and private sector to the party best able to manage them. Thus, in theory, contracting-out and PPP arrangements attempt to realize the best of both worlds: the efficiency of the private sector coupled with the government’s pursuit of public welfare. The belief that this outcome is attainable has driven the recent re-evaluation by government of its role in service delivery.

3. Economic Rationales

Fiscal Constraint and Jurisdictional Relations

Over the past two decades, governments in both industrialized and developing countries have been struggling to maintain and enhance existing services and infrastructure while reducing budget deficits and tax burdens. At the same time, the demand for public services and infrastructure is increasing. With current revenues being consumed by fixed expenditures on interest payments, healthcare, education, and social assistance, the lack of discretionary spending power is increasingly becoming apparent. Concerns have arisen about the Government of

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Canada’s ability to maintain the Canada Pension Plan, healthcare, as well as current and future infrastructure. Most recently, the state of water and wastewater systems has generated much discussion. In 1997, the Canadian Water and Wastewater Association estimated that $88.4 billion would be required for adequate municipal water and wastewater infrastructure investment between 1997 and 2012.¹¹ This makes partnerships with the private sector appealing.¹²

Additionally, despite the identification of investment need there is a lack of incentives for federal, provincial and municipal governments to enter into long-term cooperative relationships in areas in which they do not have jurisdiction.¹³ This is related to the absence of political gains. For example, provinces have an incentive to under-invest in interprovincial highways because some of the gains will go to nonresidents.¹⁴ Moreover, when collaboration occurs it is more likely to involve a project with high public visibility rather than actual need. Municipalities have lamented the fact that requests for federal aid have been directed to the construction of new facilities or expansion of existing facilities rather than for the repair and maintenance of existing infrastructure.¹⁵ The absence of sustained financial partnerships between governments has left financially strained jurisdictions with little choice but to consider private sector partners to control expenditures.

**The Principal Agent Problem and Market Efficiency**

Private individuals contract with each other on a continuous basis. There are two parties to a contract: the principal (e.g., the owner) of the good or service and the agent (e.g., the employee). The principal-agent problem arises when the principal lacks control over the agent’s actions and the interests of the agent are not fully aligned with those of the principal. The solution lies in the ability to structure and enforce an agreement that ensures that the agent acts in the best interests of the principal. Whether such a state of affairs is possible depends on the costs associated with contract structuring and enforcement.

¹⁵ Canada Mortgage and Housing Corporation (1999), p. 5.
In the private for-profit sector, market discipline through product prices, profits, stock prices, the threat of hostile takeover, and bankruptcy, provides benchmarks by which agency costs are minimized. These benchmarks allow a firm’s residual claimants (i.e., shareholders) to monitor the performance of the firm’s managers. The efficiencies arising from this environment are collectively referred to as “the ownership effect.”

First, the shareholders of publicly traded corporations desire the value of their shares to be maximized. Shareholders can monitor the performance of a firm by comparing the return on its shares with those of other firms and through time. This allows sub-optimal managerial performance to be identified. Thus, share prices and capital market scrutiny provide incentives for managers to operate efficiently in order to preserve their employment within the firm. Moreover, the ability to monitor performance through market proxies, such as profit and stock prices, enable owners to structure compensation payments to managers based on market outcomes that can more closely align the interests of owners and managers. It should be noted that the effectiveness of such incentive arrangements has been a matter of recent debate.

Second, the ability of private firms to be bought and sold (i.e., the market for corporate control) provides incentives for efficient management. A takeover of a company implies that an individual or organization believes that the company can be managed more efficiently. This indicates that present management is performing sub-optimally. Thus, the possibility of a hostile takeover supplies managers with incentives to behave in an efficient manner in order to maximize shareholder return and retain their jobs.

Third, the possibility of bankruptcy is a check on managerial behaviour. Bankruptcy is characterized “to occur when the market value of a firm’s assets fall below the value of its outstanding liabilities.” The threat of bankruptcy leads to capital market scrutiny (by lenders and shareholders) to monitor managerial decisions, such as capital investments. The potential

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17 Ibid., p. 11.
18 Recent research suggests that in many cases managers have been able to construct their own compensation packages to the detriment of shareholders. For a critique of current incentive payment structures for management see: Lucian Bebchuk, Jesse Fried and David Walker, “Managerial Power and Rent Extraction in the Design of Executive Compensation,” *University of Chicago Law Review*, (Summer 2002), pp. 751-846. The authors argue that many managers have excessive influence in setting the level and type of compensation they receive. This leads to sub-optimal incentive contracts with managers collecting rents at the expense of shareholder value.
20 Ibid., pp. 24-26.
21 Ibid., p. 24.
failure of the firm via bankruptcy will motivate the firm’s residual claimants to demand a critical assessment of the financial viability of projects undertaken by the firm (e.g., ensure that sufficient market demand for proposed products or services exists).

Another element with respect to market efficiency is the generally held belief that market discipline through competition with other firms is conducive to an organization that is more customer oriented, efficient, technologically superior and better able and willing to adapt to change. This “competition effect” leads to both internal (organizational) efficiency and allocative efficiency: firms seek to lower costs in order to offer a lower price than competitors or innovate with respect to service offerings or quality.22 Additionally, the competitive environment within the private sector gives firms incentives to continually develop specialized skills and expertise in order to remain in the market. This expertise is thought to be most useful in offering innovative ideas and production methods at the various stages (e.g., design, construction, and financing) of a project.23 Furthermore, competition in the market for a good or service also creates a competitive market for managers and employees as firms compete with each other to obtain and retain valued personnel.24 This in turn provides employees with incentives to build reputations as efficient performers in order to command premium compensation packages.

In closing this brief discussion of private ownership, it should be recognized that recent events surrounding executive compensation arrangements and dubious accounting practices by private firms (e.g., Enron and WorldCom) have raised questions about the private sector’s ability always to resolve the agency problem within the modern corporation successfully. However, despite such shortcomings, private market failings are significantly less severe than the failings associated with public provision and even public oversight of private actors.25

In contrast to the private sector, government bureaucracy is often viewed as wasteful, slow, inflexible, and more concerned with preserving or expanding its realm of influence rather than effectively delivering services. Government managers may engage in the “empire building” activities predicted by Public Choice theorists by maximizing their budgets and jurisdiction in

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22 Ibid.
order satisfy their desire for prestige, power and income. Additionally, politicians are perceived as often being motivated by short-term political gain instead of long-term social welfare maximization.

In government agencies there is an absence of both ownership and competition effects. Government managers do not face the market discipline discussed above because: (1) the government does not usually seek to maximize profits; (2) with ownership residing completely with the state there is no market for corporate control; (3) governments do not face the possibility of bankruptcy; and (4) government agencies rarely face competition. Thus, in contrast to private firms, governments face few incentives to operate in a cost efficient manner. The lack of profits and prices make cost efficiency and the demand for the good or service difficult, if not impossible, to determine. The absence of profits also prevents the government from using profit-based incentive contracts to obtain efficient management effort by public sector employees.

The lack of incentives to control costs nullifies the benefits of what many consider the government’s main advantage over the private sector: the government’s ability to borrow at lower interest rates than the private sector. However, the lower borrowing costs that the government faces “does not reflect superior capabilities to choose or manage projects.” In fact, the government’s lowering borrowing costs reflects its soft budget constraint created by its ability to tax citizens. Thus, lower borrowing costs do not imply that the government’s total cost of delivery would be lower than private sector delivery. Because projects initiated under public ownership do not face the same capital market scrutiny as private sector projects, there is no reason to expect that the government’s lower borrowing will result in the total costs of direct government delivery being lower than the total costs of private sector delivery. This point is illustrated most clearly by the massive cost overruns experienced in Ontario’s electricity sector.

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29 The public sector may be able to design performance measures to create incentives for public servants. However, if the performance measures are designed by the actors being measured they are not likely to be efficient.
30 Clive Harris, *Private Participation in Infrastructure in Developing Countries: Trends, Impacts, and Policy Lessons*, (World Bank: March 2003), p. 27.
31 Ibid.
by the state-owned monopoly Ontario Hydro and its successor company, Ontario Power Generation.\textsuperscript{32}

Many government agencies that deliver services are monopolies or face no comparable private sector competitor. This makes conducting relative service and price/cost comparisons with competitive alternatives infeasible. The lack of competition reduces the need for a government agency and its managers to perform efficiently and build a positive reputation because consumers have no options. The absence of competitive markets further weakens the need for government agencies to control costs and innovate. The lack of incentives faced by government employees to innovate is considered by some analysts to be one of the strongest cases against state provision of services.\textsuperscript{33} Additionally, government in-house production, especially at the municipal level, may be inefficient due to the small scale of its operations. The inefficiencies noted above indicate that there is no compelling reason to assume that a government monopoly would be welfare improving. In fact, the lack of market discipline faced by state agencies is likely to make government monopolies less desirable than private monopolies in many instances.

Government agencies’ lack of a “bottom-line” objective is also not conducive to detailed and precise record keeping. The issue of record keeping is best illustrated by the accounting procedures of the public and private sector. Private sector accounting rules require the depreciation of capital expenditures on an annual basis over time. This is in contrast to the traditional public sector method (until recently) of fully expensing capital expenditures in the year of acquisition. By not depreciating capital expenditures on an annual basis, the public sector may fail to recognize the need to renew its capital stock.

Evidence of government inefficiency has been well documented. It has been estimated that, in the early 1990s, inefficiencies in public sector monopolies in energy, road, water, and rail in developing countries generated losses of US$55 billion a year.\textsuperscript{34} Evidence about Canada’s infrastructure also suggests the existence of this problem. A recent study that examining

Canada’s infrastructure estimated that there are significant misallocations of investment across different sectors of infrastructure.\textsuperscript{35}

While citizens would like to monitor government activities, their ability to organize is severely limited due to differences in preferences between citizens and the multitude of government provided goods and services that require monitoring. The resources necessary to obtain information on the quality and efficiency of service delivery create more difficulties in the ability of voters to organize effectively. Further, the requirements of organization and resources will create a collective action or “free rider” problem: a citizen wants to monitor service quality and hold government accountable, but will not take action in the hope that another citizen will devote his/her own time and money to do so. This makes punishing poor service delivery through collective action a rather remote possibility, leaving little incentive for politicians to seek out information regarding the characteristics of service delivery.

\textit{The Non-Profit Sector}\textsuperscript{36}

The non-profit sector is another viable partner for contracting-out and PPP arrangements. Indeed, the non-profit sector may be superior to for-profit agents in some circumstances, such as the delivery of social services.

Unlike government agencies, non-profits face some market discipline (e.g., the possibility of bankruptcy). There are many other potential benefits from non-profit service delivery. Most importantly, the involvement of community organizations in social service delivery has the potential to reinvigorate civic engagement by increasing the participation of citizens in policy development and implementation.\textsuperscript{37} Further, those working for non-profits, such as volunteers, at the service delivery level are motivated by factors other than the profit motive, such as altruism or religion. Additionally, the fact that most non-profit personnel work within their own community should provide a strong resolve to attain successful outcomes. It has been noted that in the delivery of social services, where results are difficult to assess, the lack of a profit motive reduces the likelihood that a non-profit agency will engage in opportunistic behaviour when

compared to for-profit firms.\textsuperscript{38} The outcomes of social services are difficult to determine because they are not provided in a competitive environment, making service comparison problematic.\textsuperscript{39} Further, the individual nature of the service provided and long time horizon of provision make effectiveness measurement difficult. These problems create large difficulties in the ability to optimally price these services and may make the non-profit sector the more efficient agent for service delivery.\textsuperscript{40}

However, there are concerns about the use of the non-profit sector. Unscrupulous non-profits that channel funds into excessive employee compensation may arise. The absence of the profit motive may lead to sub-optimal record keeping, making an evaluation of the cost effectiveness of non-profit arrangements difficult. The volunteer nature of many non-profit agencies may lead to unstable service provision in the event of an economic downturn that forces volunteers and donors to cut back on the time and funds they devote to non-profit activities.\textsuperscript{41} An agency dependent on public funds may also suffer from unstable financing because of the political process. Government payments to non-profit organizations and charities may lead to a crowding-out of private donations.\textsuperscript{42} Another issue is that government funding of such institutions will lead to intrusive government control for accountability purposes via a bureaucratization of non-profit agencies, compromising the flexibility and innovation of the delivery arrangement.\textsuperscript{43}

There is no specific framework for choosing between for- and non-profit organizations. In politically sensitive areas, such as the delivery of social services, governments may find that the potential cost inefficiencies associated with the non-profit sector are overwhelmed by public opposition to for-profit involvement. Additionally, in areas such as social services, where outcomes and performance are not easily monitored, the non-profit sector may be the more efficient provider. On the other hand, in large scale physical infrastructure PPPs the only realistic choice for a partner appears to be a for-profit firm. In situations where the type of partner is of little importance, both types of delivery agents should be considered.

\begin{footnotes}
\item[38] See Panet and Trebilcock (1998).
\item[40] Ibid.
\item[41] See Hall and Reed (1998).
\item[43] See Panet and Trebilcock (1998).
\end{footnotes}

The movement towards more private sector participation in the delivery of services requires a re-evaluation of the skill set that public servants should possess in order to facilitate successful relationships with the private sector. This view initially manifested itself in the concept of the “new public management.” This reassessment of the role of government arose from a citizenry demanding that government more effectively accomplish its goals, governments viewing citizens as “clients” or “customers” of services, and the need to deliver “value for money” to taxpayers. The “new public management” is not solely concerned with more private sector involvement in the delivery of public services, but also the transformation of government itself into a more business-like operational unit that is results oriented. Therefore, the “new public management” can be regarded as a management reform focused on cost effectiveness.

With respect to the provision of public services, the new managerial imperative led to the development of the concept of alternative service delivery (ASD). A broad definition of ASD has been formulated:

“a creative and dynamic process of public sector restructuring that improves the delivery of services to clients by sharing governance functions with individuals, community groups, and other government entities.”

ASD recognizes that delivery may take place in a variety of ways between the two extremes of direct government delivery and privatization. The framework requires government to consider a continuum of delivery methods for a service and to select the one that best satisfies its budget constraints and the concerns and needs of citizens. This implies that government is faced with not only assessing whether it is effectively providing a service in terms of cost and quality, but also what degree of control it should have over provision.

Most ASD planning involves private sector participation in public sector services and infrastructure provision. Private agents are being courted by all levels of government both within Canada and worldwide at an accelerating rate with contracting-out and PPPs being the most

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44 See Aucoin (1995).
common form of initiative. Contracting-out services, such as waste disposal and construction projects, have been occurring for decades. Projects incorporating private capital through PPPs are a relatively new phenomenon. In the 1980s and early 1990s, the United Kingdom was the first country to pursue private sector financing arrangements predominantly through privatization aggressively (e.g., the Chunnel). The UK increased its use of outsourcing and PPPs in the 1990s under the rubric of Public Finance Initiatives (PFIs). It is only recently that Canada (and Ontario) has started to make a concerted effort to expand its use of the private sector. The federal government of Canada now retains consultants to offer training sessions to federal, provincial and municipal employees on how to manage PPP projects; it has created the Public-Private Partnership Office to raise awareness of the possibilities of PPPs.\(^{46}\) The government of Ontario created the SuperBuild agency to increase the use of PPPs for infrastructure projects.

A response to the business-like approach advocated by the “new public management” has come in the form of the “new governance” paradigm. The “new governance” asserts that the focus on management skills has come at the expense of “enablement” skills.\(^{47}\) Enablement skills are the characteristics required to seek out and foster relationships with other sectors focusing on collaboration and the formation of networks.\(^{48}\) There are three primary enablement skills: (1) activation skills (i.e., the ability to assemble agents to deal with public problems); (2) orchestration skills (i.e., the ability to organize and maintain groups of agents); and (3) modulation skills (i.e., the ability to provide the incentives necessary to elicit efficient performance from agents).\(^{49}\)

Management and enablement skills are both critical to successful contracting-out and PPP ventures. However, while these skills are necessary, it remains to be seen whether the public sector can develop a framework that provides itself with the incentives necessary to develop and use management and enablement skills. Involving the private sector in the delivery of public services does not necessarily mitigate the agency problems existing within the public sector. In fact, as will be discussed in the sections that follow, there are serious questions about the public sector’s ability to develop the evaluation and accountability mechanisms necessary to ensure that the public interest is properly served through ASD initiatives.

\(^{46}\) The Public-Private Partnership Office, homepage: http://strategis.ic.gc.ca/SSG/ce01380e.html
\(^{47}\) See Salamon (2002)
\(^{48}\) Ibid., p. 16.
\(^{49}\) Ibid., pp. 16-18.
5. Structuring Agreements with the Private Sector

Developing a successful relationship between the private and public sector is a challenging task. Each party has different and often conflicting goals that need to be aligned through contracts. In order to realize a successful outcome an efficient contract must be negotiated between the public and private sectors. Further, the performance of the contract needs to be effectively monitored. This requires public servants to possess and utilize management and enablement skills.

Recent analysis by Globerman and Vining has addressed the issues facing both governments and private sector parties in contractual agreements. The authors argue that recognizing the type of contracting environment is of primary importance when designing an efficient contract.

Globerman and Vining identify three costs to forming contractual agreements with the private sector: bargaining, representing the costs of negotiation, post-agreement contract modification, monitoring costs, and dispute resolution; opportunism, representing the costs of a party acting in bad faith; and production. Bargaining and opportunism costs are influenced by three main environmental factors of a project: complexity, contestability, and asset specificity. As the complexity of a task increases the more difficult it becomes to specify and monitor outcomes. This makes contract negotiation more costly and increases the potential for ex post opportunism by one or both of the parties. Contestability refers to the ease with which firms are able to produce the desired good or service. A lack of contestability may result in less price competition between contractors, collusion at the bidding stage, and monopoly service delivery in the long-run. The specificity of an asset refers to the ability to use the asset for alternative purposes. As the specificity of an asset increases the potential for ex post opportunism via hold-up of the owner of the asset also increases. Failure to address these concerns can eliminate much of the potential efficiency gains from the private sector. The uncertainty surrounding government behaviour, such as an upcoming election, may lead to higher bids or even a refusal by private agents to enter into business arrangements with government. Some analysts argue that ex post

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government opportunism through direct or indirect expropriation of a specific asset is a significant threat to private sector involvement in public goods and services provision.\textsuperscript{51}

Globerman and Vining establish a framework that allows for systematic analysis of the problems associated with the different possible combinations of factor characteristics and the development of potential solutions (Table 1).

One of the most significant issues in contracting-out and PPPs is the allocation of risks between the parties. There are a number of risks associated with the various stages of a project that require management. Optimal risk allocation requires that the risks be allocated to the party able to deal with the risk at least cost.\textsuperscript{52} A helpful guide to this task is a Nova Scotia Department of Finance discussion paper: *Transferring Risk in Public/Private Partnerships*.\textsuperscript{53} The report identifies two broad categories of risk: (1) risk within the control or management of the primary risk taker; (2) risk beyond the control or management of the primary risk taker.\textsuperscript{54} The Treasury Taskforce in the United Kingdom uses similar language stating that as a general rule risks should be transferred to the private sector “where the supplier can affect the outcome [of the project].”\textsuperscript{55} Both reports suggest that optimal risk allocation involves transferring the risks of design, finance, construction, and operation to the private sector. Risks that cannot be controlled by private sector agents such as government regulations and legislation (e.g., federal/provincial/municipal taxation or environmental standards) should be assumed by the contracting governmental body. This examination of risk reveals that an understanding of the complexity of the task being studied is critical to structuring an efficient agreement. Inappropriate risk allocation can lead to increased costs from private sector agents demanding higher risk premiums or *ex post* disputes arising with respect to the responsibilities of the parties to the contract.\textsuperscript{56}

\textsuperscript{52} HM Treasury, *Partnerships for Prosperity*, (November 1997).
\textsuperscript{53} Nova Scotia, Department of Finance, *Transferring Risk in Public/Private Partnerships*, (November 1997). The paper was issued in response to PPP initiatives spearheaded by the province’s Department of Education and Culture to build “high tech” schools.
\textsuperscript{54} The report separates risk into four further categories: ownership, operational, financial, and “Acts of God.”
\textsuperscript{55} See HM Treasury (1997)
\textsuperscript{56} National Audit Office, *Managing the Relationship to Secure a Successful Partnership in PFI Projects*, (London: The Stationary Office, 2001). One key observation was made regarding the transfer of risk: contractors may inappropriately accept risk in order to win the competition stage of the project.
<table>
<thead>
<tr>
<th>State</th>
<th>Complexity</th>
<th>Contestability</th>
<th>Asset Specificity</th>
<th>Potential Problem(s)</th>
<th>Solution(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Low</td>
<td>High</td>
<td>Low</td>
<td>Few</td>
<td>Poor performance can be punished with contract termination</td>
</tr>
<tr>
<td>2</td>
<td>Low</td>
<td>High</td>
<td>High</td>
<td>Contractor’s investment in specific asset may lead to opportunism by government</td>
<td>Government should own and lease specific assets</td>
</tr>
<tr>
<td>3</td>
<td>Low</td>
<td>Low</td>
<td>High</td>
<td>Contractor owns specific asset, lack of price competition in bidding stage</td>
<td>Contract service areas should be small (e.g. regional areas instead of provincial and/or national) and/or for short time periods; government may own and lease specific assets</td>
</tr>
<tr>
<td>4</td>
<td>High</td>
<td>High</td>
<td>Low</td>
<td>Uncertainty with respect to measuring cost and performance</td>
<td>PPP arrangement so that risks allocated to the least cost avoider</td>
</tr>
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<td>5</td>
<td>High</td>
<td>Low</td>
<td>Low</td>
<td>Lack of price competition in bidding stage</td>
<td>Contract service areas should be small (e.g. regional areas instead of provincial and/or national) and/or for short time periods</td>
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<tr>
<td>6</td>
<td>Low</td>
<td>Low</td>
<td>Low</td>
<td>Lack of price competition in bidding stage</td>
<td>Contract service areas should be small (e.g. regional areas instead of provincial and/or national) and/or for short time periods</td>
</tr>
<tr>
<td>7</td>
<td>High</td>
<td>Low</td>
<td>High</td>
<td>Many</td>
<td>Detailed analysis required</td>
</tr>
</tbody>
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Bundling

When structuring an agreement the decision to bundle project components (e.g., design, construction, and finance) together or hold separate competitions for each component must be made. Each bundling arrangement has its own set of costs and benefits.

Unbundled competitions will lead to more potential bidders for each component and therefore more intense price competition. However, unbundled competitions may reduce coordination between the many facets of a project and their associated risks, leading to higher overall costs. A bundled competition is likely to give rise to consortia or collections of firms, each with its own expertise, submitting a bid covering all aspects of a project. This integration and internalization of all components of a project with one party should decrease the likelihood of conflicts occurring between different stages of project implementation that could lead to cost overruns. For example, in an unbundled competition, the design of a structure could be focused on aesthetic qualities without concern for the construction requirements, such as building materials or the ease of construction, leading to cost increases at the construction stage.

There are many other consequences of unbundling and bundling. With unbundled competitions, especially in the area of design, more bidders lead not only to lower costs but also to more ideas through a greater number of proposals. However, since the probability of an individual firm winning the contract decreases with the number of bidders, firms may devote fewer resources to developing innovative ideas for the various components of a project. Bundled competitions would have the opposite effect of increasing the chances of a firm winning the project, leading it to devote more resources to creating ideas. A final benefit to the integration of all project components into one bid is the time and costs saved by not holding multiple competitions. Given the previous discussion regarding the nature of contracting-out and forming a PPP, in some instances the decision to pursue bundled or unbundled competition will essentially be choosing between these two delivery options.

More complex issues of horizontal bundling arise when a single infrastructure project involves multiple outcomes. Examples of this include telephone services (local, long distance, and cellular) and electricity (generation, transmission, and distribution). The decision needs to be made whether single or separate agents should deliver the multiple outcomes. The World Bank

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58 See case study of UK correctional services below.
has expressed concerns that in the instances just described the use of bundling may give rise to monopoly concerns.\textsuperscript{59} Such cases will require careful examination to determine whether the economies of scale made possible by a single provider outweigh the potential problems associated with monopoly provision.

\textit{Payment Schemes}

Another substantive challenge with respect to contracting-out and PPPs is selecting the method of payment. The traditional payment method is fee-for-service where the contractor and government agree upon a set price to be paid for service delivery. The second traditional payment method is the cost-plus contract where the contractor is compensated for costs incurred plus a pre-specified mark-up. Neither of these traditional payment methods provides strong incentives to the private sector party to deliver both quality and cost efficiency. However, with the recent trend towards developing both higher quality and lower cost service provision there has been a movement towards performance based contracts that better align the private and public interest.

A performance-based contract determines payments on the meeting of certain outcomes and objectives.\textsuperscript{60} In some activities measurement of performance is relatively straightforward, such as garbage collection; however, in others, such as correctional services, desired outcomes are not as clear and conflicting objectives may exist, such as punishment versus rehabilitation. These concerns require that governments take care to ascertain the goals of programs being considered for ASD and develop a viable framework to evaluate service delivery.\textsuperscript{61}

In response to the difficulties of measuring performance governments may attempt to incorporate incentives into contracts to elicit quality and cost efficiency from contractors. The most common incentive structures are: (1) scaled rewards, such as increasing the payment to the contractor for specified achievements; (2) shared savings, awarding the contractor a portion of the government’s costs savings; (3) performance penalties, reducing the contractor’s payment.

\textsuperscript{59} See World Bank (1994).
when specified outcomes are not met; and (4) capitated payments, establishing a fixed price per unit of service delivered.\textsuperscript{62}

It must be noted that the method of payment is an integral part of risk allocation. The payment scheme selected will largely determine the risks borne by the parties. For example, a fixed price contract places the risk of cost overruns on the private sector, while a cost-plus contract allocates the risk of cost overruns to the government.

\textit{Accounting Issues}

In many cases there will be trade-offs between the accounting treatment, risk management and allocation, and payment scheme desired by government. Specifically, the accounting treatment of the transaction (e.g., treating the transaction the purchasing of a service versus the purchasing of an asset) will change as the degree of government ownership changes.\textsuperscript{63} In some cases, a government facing strong pressures to balance its budget may pursue and structure alternative service delivery arrangements to improve its fiscal outlook at the expense of other objectives (e.g., efficient delivery) by inefficiently allocating risks to private sector partners. Accounting considerations should not be the basis for initiating alternative service delivery arrangements. The motivating factor for alternative service delivery arrangements always should be cost efficiencies and quality improvements.

\textit{Contracting-out versus PPPs}

The above analysis makes clear the key principles and trade-offs when choosing between public provision, outsourcing and a PPP. Most obvious is that a PPP takes advantage of both the competition and ownership effects of private markets, while contracting-out benefits from the competition effect alone. A contracting-out agreement entails significantly less risk transfer because the government fully finances a private party to carry-out a specific task. With a PPP the government yields control of the various stages of project development to the private sector through the shifting of responsibilities, but gains from the transfer of risk to the private sector. Loss of government control may necessitate more robust public accountability measures in PPPs than in simple outsourcing arrangements. PPPs require complex negotiations to ensure that risks

\textsuperscript{62} Moore and Hudson (2000), pp. 27-29.
\textsuperscript{63} See Nova Scotia (1997).
and responsibilities are allocated optimally and potential monopoly problems are avoided.
Another distinction that will become more evident in the case studies section is that the financial
nature of PPPs has led to them being primarily used for physical infrastructure projects, although
there has been some movement to make use of them in the provision of other services.

*Contract Management*

Once a contract has been designed and agreed upon it must be enforced. The ability of
governments to monitor agreements with the private sector is perhaps the most important aspect
of creating successful PPPs and contracting-out arrangements. The difficulty of monitoring will
depend on how well outcomes can be articulated. Monitoring ability will also be determined by
the variable(s) being used to judge success. Cost efficiency and the use of other easily
quantifiable outcome measures, such as the number of patients treated by a hospital or students
enrolled in a school, are only one monitoring option. Other objectives such as the effectiveness
of service delivery may be desired but not readily measurable or definable, requiring a
deliberative approach to managing and evaluating program delivery.64 Depending on the nature
of the variable (i.e., quantitative or qualitative) being measured, monitoring may take the form of
on-site supervision, government or independent audits (i.e., contracting-out monitoring),
customer surveys, communication with stakeholders, or other types of communication and data
collection. The monitoring problem provides further evidence that the pursuit of public interest
objectives require government to undertake in-depth analysis when deciding to involve the
private sector in service delivery. The difficulty in selecting and measuring outcomes introduces
significant difficulties in the government’s ability to use performance and incentive-based
contracts. In fact, studies have raised serious doubts regarding the ability of the public sector to
monitor the cost effectiveness of private sector agreements.65 These results give rise to the
concern that “government reliance upon the private sector has grown faster than its ability to
manage it.”66

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A report in the United States by the Commercial Activities Panel stated that following a
decade of public service downsizing, in large degree a result of increased service contracting, the
US civil service has experienced an enormous drain in both experience and knowledge.\textsuperscript{67} At the
US federal level of government, acquisition personnel decreased by 22 percent in the 1990s;
given the changing nature of government procurement the Commercial Activities Panel
concluded that the key to better practice in government procurement is to build human capital in
the form of a skilled acquisition workforce.\textsuperscript{68} The US General Accounting Office (GAO)
explicitly cites the lack of strategic human capital management by the federal government as the
primary risk to successful contract management.\textsuperscript{69} The GAO has further stated that “[t]he
government must face the twin challenges of improving its acquisition of services while
simultaneously addressing human capital issues. One cannot be done without the other.”\textsuperscript{70}

Despite a decade of experience and studies indicating that PPPs can deliver significant
cost savings over traditional public sector methods a similar situation exists in the United
Kingdom.\textsuperscript{71} In the UK, it was hoped that individual departments would eventually acquire the
necessary experience to handle future PPPs without external guidance. However, further review
of PPPs in 1999 concluded that the public sector did not possess the skills required to
successfully manage PPPs consistently.\textsuperscript{72} Specifically, the following areas were found to be
weak: strategic planning, project management, negotiating skills, financial discipline and
management of long-term contracts.\textsuperscript{73} The lack of staff continuity within the public sector was

\textsuperscript{67} See GAO (2002).
\textsuperscript{68} Ibid., p. 30.
\textsuperscript{69} GAO, \textit{Contract Management: Trends and Challenges in Acquiring Services}, Statement of David E. Cooper,
\textsuperscript{70} Ibid., p. 10. See also: GAO, \textit{Contract Management: Improving Services Acquisitions}, Statement of William T.
Woods, Acting Director, Acquisition and Sourcing Management, (November 1, 2001). The need to build an
acquisition workforce is seen as a top priority by the GAO. This led to discussion with private sector companies
regarding their contracting-out procedures. The dialogue revealed that companies have high ranking procurement
executives or chief acquisition officers to design and organize the purchasing of services; private sector firms felt
that such positions were necessary for successful outsourcing outcomes. The concerns regarding contract
management have culminated to form the \textit{Services Acquisition Reform Act} (SARA) currently under consideration by
the House of Representatives. The SARA bill proposes greater use of performance-based contracting (specifically
share-in-savings contracting) and the establishment of a chief acquisitions officer in each federal government
agency. SARA also seeks to establish better acquisitions training for federal employees by setting up a training fund
and employee exchange programs with the private sector.
\textsuperscript{73} Ibid.
also cited by both government agencies and private contractors as a serious problem. Staff discontinuity created two problems: (1) new staff had to learn the details of a deal; (2) new staff was inexperienced in managing these types of relationships. The problems encountered in the UK have led some to argue that ASD decisions are being made for ideological and accounting (i.e., off-budget financing) reasons rather than a desire to improve the efficiency and quality of public services delivery.

In an attempt to overcome the lack of entrepreneurial incentives existing within the public sector the government established Partnerships UK to further advance the use of PPPs. Partnerships UK is a PPP that assists in policy development, such as contract standardization and project evaluation. The firm only offers its expertise to the public sector.

In 2000, the United Kingdom created the Office of Government Commerce (OGC) “to work with the civil Government as a catalyst to achieve best value for money in commercial activities.” The OGC was developed following a 1999 review of government procurement. The review identified a number of weaknesses in procurement, including organization, process, people and skills, and measurement. The review recommended that the OGC be created to assist overcoming these weaknesses through the development of a common procurement framework. A department would be required to obtain authorization from the OGC to deviate from the common procurement framework. Most importantly, beginning in 2001, the OGC began to implement a “Gateway Review Process.” The Gateway Review Process “examines a project at critical stages in its lifecycle to provide assurance that it can progress successfully to the next stage.” The process involves six gateways, four prior to awarding a contract and two examining “service implementation and confirmation of the operational benefits.” A review team from the OGC

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75 Ibid., p. 18-19.
77 Partnerships UK website: [http://www.partnershipsuk.org.uk](http://www.partnershipsuk.org.uk). Partnerships UK is a PPP. It is jointly owned by HM Treasury and the private sector. Partnerships UK generates a financial return for itself through a fee on the financial closing of PFI agreements, or in the case of joint ownership PPPs, an equity interest.
81 The six gateways are: strategic assessment; business justification; procurement method and source of supply; investment decision; readiness for service; and, benefits evaluation.
analyses a project and provides a Red/Amber/Green status. However, the review team does not have the authority to halt projects.

Other methods have been adopted to augment the government’s ability to monitor private sector delivery arrangements in the United Kingdom. In 2001, the National Audit Office (NAO) published *Managing the Relationship to Secure a Successful Partnership in PFI Projects*. The study recommends the provision of “open book accounting” in contracts to provide government authorities with a better understanding of the contractor’s cost structure and financial position in order to facilitate a better working relationship. Open book accounting entails the private sector agent making its costs with respect to the service it is providing fully available for government inspection. Another beneficial aspect of such a provision would be to mitigate any cost disputes that may arise.

The UK still reports problems. A review of public finance initiatives in 2003 identifies a number of problems, most notably: improper use and calculation of expected savings to justify private sector delivery; bailing-out contractors; inappropriate use of private sector financing (e.g., used to engage in off-budget financing); and a reluctance to use contract termination provisions when projects encounter significant difficulties.

**Further Challenges**

The incentive to minimize costs may be diminished if it is perceived that the government will not allow a project to fail. The problem of governments bailing-out projects is particularly troublesome. Credit rating agencies state that they take note of such a possibility when rating the financial situation of a jurisdiction. Credit agencies monitor such behaviour because if a government develops a habit of saving failed projects or expropriating investment it is adding to liabilities that must eventually be paid for by taxpayers. The result of a lower credit rating being

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82 E-mail correspondence with the OGC (August 21, 2001). The definitions of status are: Red: To achieve success the project needs to take remedial action immediately; Amber: The project should go forward with actions on recommendations to be carried out before the next OGC Gate; Green: the project is on target to succeed but may benefit from the uptake of the recommendations.
84 Ibid., p. 13-14. The creation of dispute resolution procedures are cited as a necessity; as a result of pre-determined dispute resolution procedure only nine out of 72 government agencies surveyed went through a formal process of resolution; all other disputes were settled within the parameters of the negotiated contract.
issued because of such behaviour will leave the state’s public finances no better-off, and possibly worse off, than before. The repeated saving of projects destined to fail will also decrease the incentive for future private sector agents to provide services efficiently. This problem makes it essential for governments to evaluate rigorously the financial strength of potential partners for projects that rely on private capital, and effectively design and enforce contractual agreements.

The above concerns indicate that there is a strong need for governments to meet a series of challenges with respect to expanding private sector provision of public goods and services: (1) creating a framework that facilitates project selection and design; (2) a framework that creates the incentives necessary for the effective management of these new relationships; (3) ensuring that the government possesses a skilled acquisitions staff.

6. The Process of Project Selection

Private sector firms have long made use of outsourcing and joint venture opportunities. For example, in 1994, Nike, Inc. had contracted-out 100 percent of its shoe production in order to focus its resources on research and development. Making such a choice involves answering the following two questions: (1) Is the task vital to the company’s core expertise? (2) Can the company execute the task more effectively and/or at lower cost than an outside firm? When the answer to both questions is “no,” a firm or government may proceed to contract-out the task or form a partnership.

Core Competency

The concept of core expertise or “core competency” refers to the set of activities performed by a firm that “create unique value.” Successful companies provide customers with a good or service in a manner that consumers prefer to those of competitors. This implies that one of the “core competencies” of a firm seeking long-term success needs to be focused on understanding and assisting customers. While facing different incentives governments and their agencies need to conduct a similar assessment when deciding on the appropriate delivery

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87 James Brian Quinn and Frederick G. Hilmer, “Strategic Outsourcing,” *Sloan Management Review*, 35(4), (Summer 1994), p. 43. The article examines the decision making of private sector firms, but the same issues should be expected to arise in the public sector.
89 Quinn and Hilmer (1994), p. 44.
90 Ibid., p. 46.
mechanisms for public goods and services. A major challenge is that governments are supposed to maximize social welfare and not profits. This makes the determination of the “core competency” of government less obvious than that of a private firm. For example, a government agency may need to consider whether its “core competency” is to both regulate and deliver a service, or to ensure that services are delivered in a fashion that best serves the public interest. Once a government decides what it should be doing, it can proceed to contemplate the best way to achieve the outcome it desires.

The United States has made a serious attempt to categorize the core competencies of government. In an attempt to introduce more efficiency into the federal public sector the Office of Management and Budget (OMB) created Circular A-76. The circular seeks to engage the private sector for the delivery of services that are not “inherently Governmental in nature.” Two categories of inherently governmental functions are given: (1) the act of governing, such as judicial functions and foreign relations; and (2) monetary transactions and entitlements, such as tax collection and the money supply. A list of examples of commercial activities that may be contracted-out is given. Commercial activities range from audiovisual products and services to transportation.

The circular is supplemented by the Federal Activities Inventory Reform Act of 1998 (FAIR Act). The FAIR Act requires that federal government agencies create a detailed inventory of all commercial activities that are performed in-house. The inventory must be maintained on a yearly basis, reviewed by the OMB and made public. The FAIR Act also created a process in which parties may challenge the inclusion or exclusion of activities in the inventory. In 2001, the OMB required agencies to provide a yearly inventory of inherently governmental functions.

However, the pursuit of the public interest is a significant challenge in the contracting-out decision-making process. As one commentator has pointed out “[t]he efficient alternative need not be the cheapest.” Hart, Shleifer, and Vishny contend that the multiple objectives governments wish to fulfill leads to an inability to design contracts that comprehensively specify the outcome desired. Further, they argue public interest objectives may be impossible or extremely difficult to monitor and that private firms face strong incentives to cut costs that may dominate the incentives to produce quality innovations. In contrast, they argue that government

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agencies lack incentives to both cut costs and produce quality innovations. This leads Hart, Shleifer, and Vishny to the conclusion that government should not contract out activities when cost reductions have significant negative effects on quality and when quality innovations are trivial.\(^93\) Alternatively, outsourcing should occur when quality innovations enhance welfare significantly and when cost reductions do not have a significant impact on quality or can be controlled by contract or market discipline.\(^94\)

**Cost-Benefit Analysis**

The recommended approach for determining the differences between in-house, outsourcing and partnership delivery arrangements is cost-benefit analysis. A private firm will look at the internal costs of production compared to the costs of purchasing the function from external providers. Since many government services are delivered through monopolies, estimating costs and benefits will often prove to be difficult. The initial costs of transferring the production of a good or service to the private sector may be substantial. Specifically, in an undeveloped market the investment needed to create a viable independent supplier may be prohibitively expensive.\(^95\) This implies that switching from government to private provision may not be immediately viable. Additionally, allowing large scale provision by a private firm could lead to monopoly problems and future higher prices that outweigh the initial savings.

The calculation of the internal costs of production within both a firm and government also proves to be difficult. The interrelation of activities within an organization makes the internal costs difficult to calculate as separating the time and resources devoted to different operations is unclear. Care must be taken to not outsource or produce in-house the wrong activities. The problem of internal cost calculation will be acute in governments as multiple agencies both within and between levels of government may all be involved in the delivery of a particular service, entailing a complex process of coordination. It should also be recalled that agency theory predicts that governments face weak incentives to keep accurate records. In Canada, research at the federal level indicates that government agencies and departments rarely have reliable data on the costs and quality of the services they provide.\(^96\)

\(^{93,94}\) Ibid.
\(^{95}\) Quinn and Hilmer (1994), p. 49.
\(^{96}\) Gow (1997), pp. 244 and 254.
Additionally, a strict adherence to the results of cost-benefit analysis is not advisable because cost-benefit analysis can be biased.\(^97\) Cost-benefit analysis can be used to inappropriately recommend (as found in the U.K.) or reject the use of the private sector. The cost-benefit analysis may reflect the preferences of the analyst or government, for example, an ideological commitment to economic efficiency or public delivery, rather than a balanced assessment of the associated costs and benefits of different service delivery arrangements.

**Social and Other Costs**

As alluded to above, the government’s cost problem is complicated by the multiple objectives that it seeks to fulfill. Governments need to address concerns other than pecuniary costs and benefits, such as equity and distributional issues. Public opinion further complicates the analysis. These are legitimate causes of concern. For example, private provision may lead to lower wages through use of non-unionized labor, as well as fewer benefits, such as pension plans. This could lead to increases in claims on government health and welfare services in the future.\(^98\) These factors are difficult to quantify and incorporate into a viable cost-benefit analysis. Further complicating matters is the presence of lobby groups. A public sector employee union may seek to prevent efficient private alternative service delivery from taking place. Alternatively, lobbying by private firms may lead to inappropriate private sector involvement (e.g., delivery arrangements designed to subsidize a firm).

A potential drawback to outsourcing a key component of good or service delivery is that if market conditions change the supplier could refuse or be unable to supply, leaving the government without an alternative supplier or the necessary expertise to produce in-house.\(^99\) This raises the issue of the “de-skilling” of the public service.\(^100\) Such a problem could arise with any task, but government will need to be highly sensitive to this issue for services considered essential, such as healthcare. In extraordinary circumstances, a government might feel the need to exercise its coercive power and require delivery by law, such as outlawing labour strikes or ordering delivery of a service. The government may find it desirable to retain some in-house


\(^100\) Gow (1997), p. 255.
capacity or have transition plans in place if a change in supplier becomes necessary. However, in its new relationship as a customer, the government may be able to increase the expertise of its staff in all aspects of service delivery when it interacts with a private supplier.¹⁰¹

A critical issue is the government’s assessment of how much control it wishes to retain over the project or service involving the private sector. It should be recalled that control will largely be determined by the financing arrangement, with more power being yielded as the share of private financing (ownership) increases. The determination to be made by government is whether to fully finance the project, share financing, or leave financing entirely in the hands of private parties. These financing arrangements form a continuum from contracting-out the purchase of goods and services (full government financing and ownership) to a PPP (shared financing and ownership) to outright privatization (complete private ownership). Because governments take into account broader public interest concerns than private sector agents complex judgments will often be necessary. For example, if the new delivery model entails a user fee being charged consumers of the service will be affected in different ways depending on their income level, for example, low income users may not be able to afford the service. As a result, a government may wish to regulate the user fee.

Another significant problem associated with ASD, and primarily contracting-out and PPPs, is the phasing out, or a negative change in working conditions, of public employees. The difficulties encountered by Ontario (discussed below) highlight the sensitivity of public sector employees to private involvement in public service delivery. As a result, it is important that when an existing service is being transferred to private provision care be taken not to alienate current staff. The importance of this issue cannot be underestimated as the attitude of public service employees to contracting-out and PPP initiatives is critical to their success. It is intuitively obvious that there is little incentive for public servants to cooperate in initiatives that could lead them to lose their jobs.¹⁰²

There are a number of strategies available to limit the potential problem of public sector employee resistance. One possible avenue is consulting staff and unions when outsourcing and

¹⁰¹ Quinn and Hilmer (1994), pp. 53-54
PPPs are being contemplated. Some studies suggest that increased involvement by public employees in the decision making process yields not only less resistance, but will also lead to better decision making if experienced public workers volunteer assist in policy design. Another suggestion is that contractors be required to offer the right of first refusal for available jobs to displaced public sector employees. Alternatively, government could grant the right of first refusal to displaced public workers for new job openings within the public sector. The UK introduced legislation to protect the job security of public sector workers in the event of a transfer of service delivery from the public to private sector.

There has also been concern regarding the status of minorities within the public sector. Research on government hiring practices appears to indicate that government agencies are among the principal employers of minorities. However, other studies suggest that private firms hire displaced workers in the same proportion as government. It has been suggested that by forming partnerships with the private sector the state may be better able to influence private firm policy regarding pay equity and working conditions by using its ownership stake as leverage. The same policy objectives could be applied to more basic contracting-out arrangements. The labour issues discussed here are likely to be less relevant if the services being considered for private delivery are new services.

The above concerns illustrate once more that government cannot simply act as a manager concerned with cost efficiency when making decisions regarding service delivery. It also needs to consider its broader mandate to advance the public interest and other political constraints,

105 Ibid.
106 Ibid.
107 The UK provides an example. In 1981, legislation was enacted to protect public sector employees in the event that their job is transferred to the private sector: Transfer of Undertakings (Protection of Employment) Regulations, referred to as TUPE. The purpose of the law is to ensure continuity of employment and working conditions when transfer occurs, TUPE has the effect of transferring the responsibility of fulfilling the existing government negotiated employment contracts of current employees to the new deliverer of the service. This includes the preservation of the terms of the initial contract in future contract rounds. The government has also pursued measures to safeguard the pensions of former public staff. Other ideas under consideration for increasing the incentives for public sector to see a PPP succeed include the offering of an equity stake in projects to public sector employees.
109 Ibid.
implying that effectively engaging the private sector in the delivery of public services is a more complicated exercise than some policymakers and analysts realize.

7. Contract/Partnership Award Process

There are a number of options the government can use to solicit private participation in service delivery. In the past, the most common method saw the government tender a project. Tendering involves the government setting out in specific terms how a service or infrastructure project should be provided with little if any information requested from the bidders except for their qualifications and the price of their services. The contract will be awarded to the qualified bidder able to fulfill the requirements of the agreement at the lowest cost.

Recently, the use of Request for Proposals (RFPs) has become more common. RFPs are less detailed than a tender. The government merely states the intended objectives of the project, leaving the specifics of the delivery mechanism to be proposed by the bidding parties. The latest trend has been the introduction of Requests for Conceptual Proposals (RFCP). In an RFCP, government suggests the broad area in which they considering a project and requires the bidding firms to propose an original project idea and the method of delivery. A final possibility is sole-sourcing, no competition is held and the government approaches and negotiates with a single firm.

The government may also split the competition process in the tendering and RFP frameworks into two segments by first issuing a Request for Qualifications (RFQ). The RFQ model is desirable because in highly competitive markets a single stage competition may lead to a lack of investment in proposals by companies due to the lower probability of winning. A possible solution is the subsidization of proposals or a two-stage process. An RFQ will outline the basics of the project being contemplated and request interested parties to submit their qualifications. Thus, an RFQ reduces the initial costs of bidding and may increase the number of firms in the competition. The government evaluates the qualifications of the participants and issue RFPs to those deemed qualified to undertake the project. The risk of using an RFQ is that the most efficient provider could potentially be eliminated at the first stage of the competition.

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The preceding discussion pertained to solicited proposals in which the government announces to interested parties its intentions to initiate a project. This process relies on the public sector identifying possible options for private sector involvement. Relying on the internal generation of ASD initiatives necessarily limits the number of initiatives that will be pursued. A solution to this is permitting private parties to come forward with unsolicited project ideas and/or delivery designs to the government.\footnote{Ibid.} Allowing for unsolicited proposals will fully exploit the innovative capacities of the private sector. An unsolicited bid implies that the private sector has conducted its own evaluation of the project. However, the private sector evaluation will likely be biased on the side of private gain. Therefore, upon receipt of the proposal the government should conduct its own evaluation to ensure that the broader public interest is served by the proposed project. It has been suggested that the threat of unsolicited proposals resulting in a shift of delivery from the public to the private sector may provide the necessary incentive for government agencies to become more cost efficient and customer oriented.\footnote{Ibid.}

If the unsolicited project is viable, the government must decide how to award a contract. The government faces significant trade-offs in this situation. If it pursues a sole-sourcing arrangement it loses the efficiency of price competition while preserving incentives for private agents to develop unsolicited proposals. The direct negotiation that occurs with sole-sourcing has the added advantage of fostering a less adversarial bargaining process; such negotiations have a greater probability of forming stable long-term relationships. Deciding to proceed with a competitive bidding process will have the opposite effect. In practice, government departments and agencies have their own guidelines regarding the submission of unsolicited proposals with most dealing with research or technological development. Whether separate departments or a central agency within the government would be more efficient to evaluate unsolicited proposals has been the subject of debate.\footnote{Ibid.} Therefore, care is required to make optimal use of the relatively untapped potential of unsolicited proposals.

For example, British Columbia has established a best practices PPP guide for physical infrastructure projects.\footnote{British Columbia, Ministry of Competition, Science and Enterprise, \textit{The Province of British Columbia's Best Practices Guide to Public-Private Partnerships}, (1998).} The guide sets out the criteria for conducting a PPP from project selection to implementation. Of note is the inclusion of a procedure for the appraisal of
unsolicited proposals. A unsolicited proposal needs to meet one of the following two criteria: (1) “the proposal relates to a need for a facility previously identified and ranked in the program agency’s list of capital projects, approved by Treasury Board” or (2) “the proposal addresses a programmatic need which has not been identified as a project in the agency’s list of capital projects approved by Treasury Board.” If the proposal meets one of the above criteria, a provincial ministry may then conduct its own evaluation of the viability and utility of the project. Following the evaluation of the proposal in consultation with other agencies (e.g., the Provincial Treasury), it may decide not to pursue the project, proceed with a competitive procurement process or negotiate directly with the party submitting the proposal.

It must be noted that in some cases government will not have discretion with respect to selection of a competitive process or sole sourcing. International trade agreements such as NAFTA and GATT have made competition mandatory for certain contracts.\textsuperscript{116} International obligations such as these limit the potential efficiency gains from sole-sourcing. In the event of an unsolicited proposal, a government may have no choice but to hold a competitive bidding process with no preferential treatment given to the proposal creator.

8. Managing the Process

Relationships with private for-profit firms in the form of a PPP are still a relatively new phenomenon in Canada and are regarded with some skepticism by many citizens and certainly by public sector employee unions. Recent revelations at the municipal and federal levels of government raise serious questions about whether contracting-out arrangements are being handled responsibly. Evidence of violations of tendering procedures and allegations of corruption has led to a freeze on certain types of federal government procurement. In addition, the private sector and government have their own concerns regarding the desirability of entering into contractual arrangements with each other. The key to any successful public-private sector relationship is to create an environment where all parties involved feel confident that their objectives will be satisfied. Establishing such an environment requires an open, fair, and transparent process for partner selection, contract enforcement, performance evaluation, and dispute resolution.

As noted above, the change from strict public provision of a service to one of private provision is likely to be met with some degree of suspicion from citizens due to concerns that private firms are more concerned with profits than the delivery of quality service. Additionally, public choice theory has formulated hypotheses regarding the reaction of the public to contracting-out and similar cost saving initiatives. Citizens may believe that savings from outsourcing will be retained by government and reallocated to other government activities rather than being returned to taxpayers in the form of tax cuts.\footnote{117} This proposition partially may explain the indifferent or hostile attitudes that some citizens express to government initiatives to involve the private sector in service delivery. An individual taxpayer makes use of only a small fraction of government services. Thus, the belief that cost savings will not be returned in the form of tax cuts or increases in the quantity and/or quality of the services that the individual consumes may lead to resistance to the alternative delivery options discussed. Also, citizens may be skeptical about whether they are receiving “value for money” in these arrangements and not have a clear understating about the party ultimately responsible for service delivery.\footnote{118} Additionally, the public may be sensitive to distributional issues, such as the effect of user fees on low income citizens, which may arise because of private sector delivery.

These concerns put pressure on governments to prove the integrity and utility of private sector delivery arrangements. Most jurisdictions have conflict of interest rules to maintain the integrity of the procurement process and hire expert consultants to oversee the process. However, additionally safeguards are necessary. For example, in Massachusetts, the state legislature passed into law the requirement that all “privatization”\footnote{119} initiatives in excess of US$100,000 be approved by the state auditor.\footnote{120} Such a safeguard may be an effective tool for preventing the

\footnote{118} Salamon (2002), p. 38.
\footnote{119} In Massachusetts, the term “privatization” includes any activity that involves the for-profit sector.
\footnote{120} The Massachusetts legislation was the product of an acrimonious battle between the Republican Governor who aggressively pushed for privatization of public services and a Democratic held senate in 1993 and is examined in Bruce A. Wallin, “The Need for a Privatization Process: Lessons from Development and Implementation,” \textit{Public Administration Review}, 57(1), (1997), pp. 11-20.

According to the Massachusetts Office of the State Auditor (MOSA), the auditor must certify that the agency follow the state’s guidelines for privatization:

“The cost of performing the service by the private sector must be less costly than having the work done by state employees, and the quality of services provided must be equal or better […]

Pursuant to this law, the privatization process includes preparing a detailed statement of services to be used in soliciting competitive bids, estimating the most cost-efficient method of providing
ideological or accounting based use of alternative service delivery arrangements. The UK’s creation of the OGC and a Gateway Review Process (see above) represents another, more comprehensive, model for increasing oversight over government procurement; although it should be recalled that the review team does not have the authority to halt a project or enforce its recommendations.

The private sector must be assured that the process is fair and well organized. In Canada, the private sector has criticized the federal government’s infrastructure initiatives as being poorly designed, managed, and susceptible to undue political pressure. The ideal method of ensuring a well managed process is one in which both the desired outcome and the criteria that the government will use to evaluate proposals are clearly indicated to all parties prior to the development of proposals. In terms of ensuring fairness, after the contract is awarded losing parties should be given the opportunity to review the evaluations of the bids received. However, in the absence of the government voluntarily disclosing results or passing legislation requiring evaluations to be made public, a bidder has few avenues of recourse. Even with access to information statutes at both the federal and provincial level, an aggrieved party may still be unable to gain access to results due to restrictions on access to commercial information, as well as the possible invocation of crown privilege.

There are other avenues available to unsuccessful bidders in international law. Canada is signatory to a number of international trade agreements (e.g., GATT and NAFTA), containing provisions for ensuring transparency and fairness with respect to government procurement (including bid challenge procedures). However, there is enough discretion left to governments that these mechanisms are of limited value. A final concern of the private sector is that agreements entered into by a government will be honored in the event that a new government

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those services with agency employees, and, finally, comparing the in-house cost with the cost of contract performance. Additionally, the agency is responsible for ensuring that the private bids and private contract, if ultimately awarded, contain all Chapter 296 provisions regarding wages, benefits, and personnel[…]

Under the privatization law, the State Auditor has 30 business days from the date of receipt of all necessary agency documents to approve or reject the contract.”

(Source: MOSA website: http://www.state.ma.us/sao/privatization.htm)

122 See Atwood and Trebilcock (1996).
123 Ibid.
takes power prior to the completion of the contract.\textsuperscript{124} Such concerns are effectively addressed by including monetary penalties for contract termination and contract violations.

Past case studies of PPPs and outsourcing have encountered serious difficulty in evaluating the arrangements due to an inability to review the final contracts negotiated between the public and private sector.\textsuperscript{125} Given that the failure to disclose the details of such arrangements compromises public accountability it has been suggested that contracts be made public.\textsuperscript{126} At the same time, it is recognized that private sector participants have legitimate concerns with respect to proprietary information contained in contracts (e.g., payment structures for employees) that can have serious competitive implications for a firm.\textsuperscript{127} A summary of the winning and losing bids, if any, could also be publicly released.\textsuperscript{128} Technology has made distributing such information virtually costless. For example, the city of Indianapolis currently makes the results of competition for city contracts available on the Internet.\textsuperscript{129}

Additional concerns of government and the public are the prevention of collusion in the bidding stages and private sector opportunism. The best safeguard against collusion or price fixing is the conducting or commissioning of a preliminary cost estimate by the government with respect to the costs of private production prior to accepting bids. Prevention of private sector opportunism and monitoring procedures rely on educating public service personnel on how to effectively communicate and negotiate with the private sector in order to get the best contract for taxpayers (i.e., maintaining a skilled government acquisitions staff). The presence of an incentive structure that would elicit such behaviour from the public service is also required.

The problem of potential bidders lobbying public sector officials to award contracts to them during the bidding process is a source of concern. This problem has been recognized and some jurisdictions have incorporated anti-lobbying clauses that disqualify bidders who attempt to lobby officials.\textsuperscript{130} Lobbying issues may also arise \textit{ex post} when the interests of government and the private partner are too closely aligned. For example, the lobbying problem may occur in the case of prison operation. If the private partner is paid on a per-prisoner basis, it may lobby for

\begin{itemize}
\item\textsuperscript{124} See Daniels and Trebilcock (1996).
\item\textsuperscript{126} Ibid.
\item\textsuperscript{127} Rosenau (2000), p. 230.
\item\textsuperscript{128} Bederman et al. (1996).
\item\textsuperscript{129} City of Indianapolis, Purchasing Division website: \url{http://www.ci.indianapolis.in.us/purch/}
\item\textsuperscript{130} See Bederman et al. (1996).
\end{itemize}
increased sentences and prison time for less serious crimes; legislatures may agree with such a plan to gain votes for displaying a “tough on crime” image.\textsuperscript{131} The result would be higher incarceration rates and total costs of incarceration.\textsuperscript{132} This result may not be socially desirable. Given this concern, the inclusion of an anti-lobbying clause in the contract negotiated with the winning bidder is desirable; such a clause would have the double effect of preventing firms awarded contracts from giving political donations for future contracts and from being pressured by politicians to make contributions for contracts already issued.

It should be recognized that the pursuit of accountability comes at the expense of cost minimization, requiring a balance to be reached between these competing objectives.\textsuperscript{133} Increasing accountability measures at the various stages will have a variety of outcomes. For example, strong accountability mechanisms will increase public acceptance of a project and better ensure that cost savings and quality improvements are realized. However, it will also increase the duration and costs of participating in the procurement process for government and bidders and delay project implementation. Therefore, judgment needs to be exercised to strike the right balance between cost minimization of the process and accountability when developing relationships with the private sector.

9. Institutional Implications

The preceding discussion reveals that contracting-out and PPPs require government to approach the delivery of public goods and services in a different manner than in the past. It involves more than simply procuring goods and services. However, relying on philosophies such as the new public management or the new governance is not enough. The ability of a government to make efficient decisions is unclear. The necessity of private sector participation in service delivery has been motivated by the inability of the state to practice the same discipline as a private sector agent. Yet, a key component to creating efficient private sector relationships is for the public sector to behave as if it was subject to market discipline. The heart of the matter lies in the ability and incentives within the public sector to manage private sector delivery arrangements throughout a project’s lifecycle. Without the ability and incentives to effectively manage

\textsuperscript{132} Ibid.
alternative service delivery arrangements there is no compelling reason to assume that private sector service delivery will improve public services. How this difficulty can be overcome is uncertain; greater authority to government auditors, Partnerships UK and the Gateway Review Process are attempts to address this problem.

Private sector involvement in public service delivery may foster better relationships between various levels of government. As noted earlier, Canada has experienced a lack of cooperation between governments that to some extent explains the necessity of private finance and service provision. PPP initiatives have the potential to encourage collaboration between multiple levels of government and the private sector by decreasing the amount of resources needed to be contributed by each party in order to fund projects. This requirement may facilitate a more cooperative process of policy making between the various levels of government in order to streamline the PPP process.

In Canada, the phenomenon of more cooperative arrangements between jurisdictions is occurring. Collaboration has taken the form of the *Federal-Provincial-Territorial Working Group on Private-Public Partnerships* in 1997. The Working Group was given the mandate of examining the possibility of a national highway program and was comprised of members from the federal government as well as each province and territory. The Working Group concluded in 1999 that outsourcing and PPP arrangements should be pursued, mainly through operation and maintenance contracts and design-build-finance-operate partnerships.

10. The Ontario Framework

The previous Ontario government was an aggressive promoter of using PPPs and contracting-out arrangements. As a result, Ontario possesses a large amount of material on the subject of ASD.

*ASD Implementation Policy*

Ontario currently has a number of documents outlining its approach to dealing with ASD, PPPs and procurement in general. Various guidelines include: the Management Board Secretariat’s (MBS) *Alternative Service Delivery Framework* (the Framework), *Procurement*

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The Framework calls for all ministries and agencies to re-evaluate their systems of service delivery. Supplementing the Framework, the OPSRS kit states that “[w]here there is no compelling reason for direct delivery, the government will pursue alternative models, including greater involvement of the private sector.”\(^\text{136}\) The kit provides six criteria for a ministry to consider when making decisions about service provision: the public interest, decision-making autonomy (the degree of government involvement), financial autonomy (the degree of government funding), management and administrative flexibility, applicability of market forces, and cost-benefit analysis.\(^\text{137}\) However, little guidance beyond a basic definition of these terms is given. The weight that should be assigned to each criterion is left to the discretion of ministries and agencies. More definitive instructions establishing a consistent method of analysis would greatly assist decision makers. The Framework requires ministries to have their ASD strategy approved by the Management Board of Cabinet (MBC). However, the MBC will review a ministry’s overall ASD plan only; once the plan is approved the development and approval of specific projects are entirely the responsibility of the ministry concerned. However, in April 2003, procurement directives were revised. Ministries will now be required to prepare a submission to MBC outlining the business rationale for proposed procurement projects with an estimated value of $1 million or more. MBC approval of the business rationale will be necessary for the project to proceed.

In contrast to the guidance provided by the Framework is a template for cost-benefit analysis issued in the Ontario Management Board Secretariat’s Guide to Preparing a Business Case for Alternative Service Delivery (Business Guide).\(^\text{138}\) The template provides a checklist of pecuniary costs that should be examined when comparing the costs of a ministry’s present delivery system versus an alternative scheme. The creation of a similar checklist for the criteria contained in the Framework is advisable. The Business Guide states that the analysis undertaken


\(^{137}\) Ibid., pp. 8-9.

“must be able to withstand public scrutiny,”

although the degree of rigor that constitutes acceptable analysis is left undefined. Additionally, the Business Guide encourages ministries and agencies that share responsibilities to cooperate together on ASD initiatives.

Overall, there is too much discretion permitted in the assessment and implementation of ASD projects. While the Business Guide and the Framework are useful, they are not sufficient to overcome the incentive problems existing within government because there is no obligation to comply with them. The use of legally binding rules for ASD assessment and implementation would mitigate agency problems, such as the requirement of provincial auditor approval of projects in excess of, for example, $200,000, and that the cost-benefit analysis be made publicly available.

_SuperBuild_

The 2001 Ontario Budget estimated that the province has $210 billion in infrastructure, of which 48 percent is publicly owned. In 1999, the provincial government created the SuperBuild Corporation to be the central agency in charge of managing all public physical infrastructure projects. It replaced the former infrastructure system that saw individual ministries being allocated infrastructure budgets to spend at their own discretion. SuperBuild’s mandate was to invest at least $20 billion in infrastructure by 2004, with $10 billion being contributed by the provincial government and at least $10 billion from private and public sector partners. The newly elected provincial government has replaced SuperBuild with the Ministry of Public Infrastructure Renewal.

There were a variety of reasons why the provincial government deemed it necessary to delegate infrastructure decision making to a single agency. The main reason was a perceived misallocation of infrastructure investment. A primary cause of this misallocation of investment was caused by government agencies fully expensing capital expenditures in the year of acquisition. Such accounting procedures led to assets not being depreciated, leading to both an inability to calculate the value of assets over time and determine reinvestment needs. In order to qualify for capital investment funds from SuperBuild, ministries (and other institutions such as

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139 Ibid., p. 2.
140 23.7% owned by municipal governments, 8.9% by the provincial government and 5.6% by the federal government.
universities and hospitals) were required to maintain records of their current capital stock and forecast future needs. When a ministry approved a capital project it was required to forward the plans to SuperBuild. The Cabinet Committee on Privatization and SuperBuild then assessed and prioritized the plan as it related to the province’s overall infrastructure needs. Centralizing capital investment decision making within a single organization is expected to ensure that project decisions are made in a consistent manner.

SuperBuild’s *A Guide to Public-Partnerships for Infrastructure Projects* (the *Guide*) outlines a framework for determining how and under what circumstances a PPP initiative should be undertaken by public sector employees. Unfortunately, SuperBuild’s PPP guide blurs the line between PPPs, traditional outsourcing and privatization by explicitly including divestiture, as well as service and management contracts within its definition of PPPs. SuperBuild gave a broad and vague definition of a PPP, stating that a PPP existed “where the interests of the public and private sectors come together in the interests of taxpayers to meet the needs of public infrastructure development and services.”

The *Guide* indicates that cost savings are not the sole determinant in deciding to undertake a PPP project; other considerations include the “potential for economic development, creating taxable wealth, stimulating innovative solutions and other non-financial benefits.”

The *Guide* proceeds to outline six criteria that are to be used to evaluate a potential PPP project: financial, technical, operational, acceptability, implementation, and timing. Financial criteria include the requirement that the public sector conduct a business-case analysis evaluating both public and private delivery options. Technical criteria consist of assuring that proper monitoring mechanisms are in place to judge performance. Operational criteria consist of the ability to set operating and maintenance standards. Additionally, the operational criteria state that the potential for regulatory changes over time must be taken into account. The acceptability criteria state that the support of the public, legislators, public sector staff, and other stakeholders within the system must be examined. The implementation criteria observe that a number of potential bidders will determine the gains from a competitive bidding process, and that the lack of potential bidders may result in sole sourcing being a more appropriate mechanism. Further implementation issues include whether there are any regulatory or legislative limitations on a PPP approach, and the

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143 Ibid., p. 4-10.
ability to transfer operations smoothly from government employees to the new delivery structure. Timing criteria involve the assessment of whether the project time frame will allow for an adequately designed project plan.

The Guide examines the implementation and operation of a project and attempts to outline a process that balances the need for “value for money” while also ensuring that the process is “fair, open and transparent.” Four phases of a PPP project are identified: scoping the project, the selection process, negotiations, and implementation and operation. Scoping the project entails conducting an evaluation of the six criteria discussed above. The selection process involves selecting the number of stages of the competitive bidding process, setting evaluation criteria for bids received, and outlining a process for bidder briefings and questions. The Guide recommends that the bidding process should select a two stage process (RFQ followed by an RFP) when there are high costs associated with an RFP, and that criteria used for evaluating bids be detailed and established before the RFP is issued. The provincial government makes all RFPs available on the Internet.

Additionally, the Guide recommends the creation of minutes for bidder briefing sessions, a process for successfully dealing with bidder questions, the creation of appropriate confidentiality protection for proprietary information and intellectual property, and the monitoring of the relationships between team members and bidders. Regarding negotiations the Guide advises the government to issue a final version of the contract before proposals are received to avoid contract renegotiation problems. In the final phase of implementation and operations it is noted that government routinely does a poor job of monitoring performance once the development phase of the project concludes. While it is suggested that a team be appointed to monitor partner performance there are no specific recommendations on the characteristics of an effective monitoring strategy to prevent nonperformance and opportunism.

The Guide represents a useful start to developing a framework for the creation of PPPs. However, like the previously discussed guidelines, it suffers from a lack of detail regarding how the various criteria used for project and partner selection should be weighted and evaluated. There is also no legal obligation for the agency to implement the framework presented in the Guide. Furthermore, while the Guide notes that PPPs may yield benefits far beyond simple cost

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144 Ibid., p. 17-20.
145 Government of Ontario RFPs are available on the electronic tender service MERX (http://www.merx.bmo.com). While viewing the RFP is provided free of charge, there is a fee for downloading the application forms.
savings, it does not provide any guidance as to how such benefits should be evaluated. Also, given the critical importance of effective monitoring procedures to the success of any outsourcing and PPP arrangement it would be highly advisable for a detailed monitoring framework to be articulated. An additional problem is that the Guide focuses on the public sector perspective of PPPs and does not address private sector concerns regarding expropriation of investment. A final concern is that the SuperBuild publication is meant to deal exclusively with hard (physical) infrastructure projects and not soft (service) infrastructure.

Evidence indicates that SuperBuild experienced difficulty developing private-sector partnerships. By July 2002, the agency had initiated $13 billion worth of infrastructure projects. However, only $4.4 billion of the spending was partnership money, and a substantial portion of the partnership funds came from the federal or municipal governments.

Labour Issues

Ontario has encountered fierce resistance to many of its attempts to engage the private for-profit sector in public service provision. Labour unions have consistently criticized efforts to involve the private sector as opening the door to corruption and a lack of accountability in public service provision. In 1997, the Ontario Public Service Employees Union (OPSEU) succeeded in delaying a number of highway maintenance contracts. The Grievance Settlement Board agreed with the union’s complaint that the government did not adhere to the 1996 collective agreement made with OPSEU that requires the government to make “reasonable efforts” to locate jobs with the new service provider in the event that work is transferred to the private sector. Another highway maintenance contract encountered similar difficulty in 1998. OPSEU also led a community campaign against contracting-out the operation of a new mega-jail to a private firm in Lindsay in 1998. The government eventually decided to outsource the operation of the new Penetanguishene jail. Interestingly, the jail facility experienced the opposite problem of highway

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147 Ibid.
149 OPSEU Press Release, Grievance ruling rocks road privatization plans, (February 20, 1998).
maintenance. Many public service employees refused to work for the private operator. As a result OPSEU argued that the new jail would be staffed by inexperienced workers.\(^{151}\)

These disruptions imposed costs on the citizens of Ontario through courts costs, and in the case of highway maintenance, may have delayed needed repairs and maintenance. The private sector experienced the cost of having contracts suspended and increased costs for the search for new personnel when public employees refused to switch employers. A portion of these costs could have been avoided if the government had made better attempts to find employment for affected public employees with the new private providers or elsewhere within the public service.

Resistance by public sector unions is to be expected. The failure to establish a less adversarial relationship between the provincial government and OPSEU has the potential to discourage further for-profit sector involvement in service delivery. Indeed, such disruptions may result in the costs of transferring responsibility to the private sector more costly than keeping service provision within the public sector. The success of OPSEU campaigns also indicates the need for the proponents of private sector delivery, both within and outside of government, to better demonstrate to the public that private sector delivery arrangements result in better service delivery, such as lower costs and higher quality.

11. Evidence on Contracting-out

There are a number of studies that have examined the results of contracting-out the delivery of public services.\(^{152}\) A substantial amount of research has examined municipal garbage collection. A number of studies have revealed that public collection is 15 to 60 percent more expensive than private collection.\(^{153}\) An examination of garbage collection by Canadian municipalities revealed that public collection was 41 percent more expensive than private collection.\(^{154}\) The impact of contracting-out in other sectors has also been examined. An analysis of bus services in Ontario municipalities observed private provision to be significantly less

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\(^{152}\) All studies referred to in this section are cited in Harry Kitchen, “Efficient Delivery of Local Government Services,” Discussion Paper 93-15 (Kingston, Ont.: Queen’s University, School of Policy Studies, 1993) and Savas (2000).


expensive than public provision. A study of electrical utility maintenance in Canada found that outsourcing to private firms was significantly less expensive than in-house provision.

Research in the United States provides further evidence of private sector cost efficiency. An examination of debt collection services revealed that government provision was 200 percent more costly per dollar of debt pursued than outsourcing. Government provision of weather forecasting services was found to be 15 percent more costly that contracting-out arrangements. A study comparing private and public provision of fire protection found municipal fire departments to be 39 to 88 percent more expensive per capita than the private alternative. In Los Angeles County, an examination of the county’s contracting-out arrangements for services, such as food, laundry, and guard services, from 1979-1989 found that contracting-out yielded savings of 28 percent. Further, a study of the outsourcing of commercial functions by the U.S. Department of Defense over the period 1978-1994 concluded that the savings from private provision averaged 31 percent. A GAO review of federal building office cleaning found that in-house staff was 62 percent more expensive than outsourcing.

Studies of the international experience have produced similar results. A study in West Germany found that publicly provided bus transportation was 160 percent more costly per kilometer than private provision. Public provision of cleaning services in West Germany was found to be 40 to 60 percent more costly than private provision. An examination of contracting-out in Western Australia for 1993-1994 revealed that such arrangements yielded average savings of 20 percent. A study of garbage collection in the UK found public provision to be 20 percent less efficient than private provision.

157 Ibid.
158 Ibid.
159 Ibid.
164 Ibid.
165 S. Farago, C. Hall, and S. Domberger, Contracting of services in the Western Australian public sector, (Sydney: University of Sydney, Graduate School of Business, 1994) as cited in Savas (2000).
166 Donahue (1989), p. 65
This review of the experiences of outsourcing indicates that private sector provision of public services is capable of delivering considerable cost savings over traditional government service delivery.

12. Case Studies

I. Information Technology

A. Ontario

In 1980, the Ministry of Consumer and Commercial Relations (now the Ministry of Consumer and Business Relations) created the Province of Ontario Land Registration Information System (POLARIS) to modernize Ontario’s land registration system from paper and microfiche into electronic format.

In 1988, an RFP to automate the land registration system was issued and sent to 21 firms, some of which had submitted unsolicited proposals a year early. The firms formed two consortia that submitted proposals. Initially, after being evaluated both by internal government and external assessment teams, neither proposal was accepted. The failure of the initial RFP to generate acceptable bids delayed the implementation of the project, as well as creating unanticipated negotiation costs. This highlights the necessity for government to conduct a thorough analysis to determine the outcome desired and the ability to clearly articulate the desired outcome to bidders in the RFP.

The government proceeded to enter into simultaneous negotiations with each consortium, leading to the selection of Teramina Holdings Inc. in 1990. The final agreement between the government and Teramina Holdings Inc. was signed on February 15, 1991, leading to the

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168 The five members of the consortium were EDS Canada, SHL Systemhouse, KPMG, Intergraph, and Landata International Services.
formation of Teranet Land Information Systems, Inc. (Teranet). The License agreement transferred full ownership of POLARIS from the province to Teranet for a 10 year period. The ownership structure of Teranet is equally split between the Ministry and Teramira Holdings Inc. Each partner contributed $29 million to Teranet for their equity share in 1991. By virtue of its equity share the Ministry was entitled to 50 percent of any dividends and distributions issued by Teranet. The Ministry collects and sets the fees that Teranet may charge users for electronic access to land registration and related services. The licensing agreement entitled the Ministry to a royalty of 25 percent from registration-related revenue and 5 percent from other non-search services.

Other provisions in the contract negotiations revolved around the placement of POLARIS public sector workers. Three principles were adopted: (1) Teranet would attempt to make offers of employment to all POLARIS workers; (2) compensation would be structured so that no public sector employee would be made worse off as a result of the partnership; (3) the government would attempt to find employment for employees who did not accept or were not offered Teranet positions. Of the public employees offered Teranet placements 78 percent accepted. The sensitivity shown to employees regarding future employment led to the absence of labour confrontations that have recently plagued other such arrangements with the private sector.

By March 31, 2000, Teranet had generated $235 million in fees from its services. The Ministry received $45 million in royalties from these revenues. No dividends were declared.

Through the joint venture the government was able to transfer the costs of research and development of the POLARIS system onto the private sector, saving the province $300 million. Teranet has been able to use its POLARIS expertise to expand into a wide variety of data management fields and export its knowledge to overseas markets. It is currently working on a variety of data management projects with governments in the Czech Republic, Lebanon, Jamaica, Puerto Rico, and the Republic of Korea. This illustrates the ability of PPPs to contribute to international business competitiveness by creating new industry expertise.

However, the POLARIS project has encountered numerous difficulties. The initial estimated cost of implementing POLARIS was $275 million with 100 percent of properties converted to electronic format by November 1999. In December 1993, the partnership was

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169 There were four agreements: a Strategic Alliance Master Agreement, Shareholder’s Agreement, Implementation and Operation Agreement, and License Agreement.
170 Ownership included POLARIS software, hardware, licenses, and trademarks.
amended by extending the automation completion date to November 2000. In 1998 the deadline was extended to March 2004. In April 1999, various estimates indicated that it would cost from $700 million to over $1 billion to complete the project. In 2002, the deadline for completion was extended to September 2007. Only 87 percent of all properties are to be fully converted to electronic format. The project was estimated to cost $680 million.

In 2002, POLARIS was also renamed the Electronic Land Registration System (ELRS). The agreement between the province and Teranet was renegotiated, requiring Teranet to give quarterly implementation reports to a joint committee created to monitor project implementation. The new agreement also required the development of a transition plan to allow the transfer of the ELRS to a new provider should Teranet become insolvent or unable to fulfill its contractual obligations. In August 2003, the province sold its interest in Teranet for $370 million.

The series of deadline extensions and increases in implementation costs raise serious concerns. These include issues about the government’s ability to monitor performance, a possible unwillingness to allow a project to fail, the lack of a plan to switch service providers, or inadequate analysis of the viability of the project at the initial stages of negotiation. Ultimately, the problems encountered strongly indicate the importance of developing a set of formal procedures for selecting private sector delivery arrangements, monitoring the performance and the enforcement of contracts with government partners, as well as ensuring that public servants possess the skills and incentives necessary to carry out these functions beyond the negotiation stage of such projects. The above problems indicate that an efficient arrangement may have very well been to privatize Teranet from the outset.

B. United Kingdom

In the United Kingdom, Inland Revenue (IR) is responsible for tax assessment and collection. One office within the department was the Information Technology Office (ITO). The ITO was responsible for IR’s mainframe computers that performed electronic assessment of employed and self-employed taxpayers and tax collection.

In 1992, it was determined that ITO could be more efficiently operated through a strategic partnership with the private sector. This conclusion was reached after an in-house versus private sector cost comparison of operations was conducted by outside consultants hired by IR. IR’s reasons for contemplating contracting-out were standard: the complexity of developing its own technology in-house, difficulty in attracting, retaining, and training staff, and a desire to achieve cost efficiency.

A request for expressions of interest was issued in 1992 with six firms responding. Two firms were short listed and a tender document was sent to each. With the assistance of external consultants IR evaluated the two bids. Customers of the bidding firms were interviewed as part of the evaluation process. In 1994, the IT services were contracted-out to Electronic Data Systems Limited (EDS) for a ten year period.

The deal included the transfer of ITO assets and personnel to EDS. 1900 ITO staff were transferred to EDS over a two year period. Focus groups were set up to hear staff concerns regarding the transfer. Under the TUPE legislation, ITO employees that were transferred to EDS were employed on their current contract terms. The pensions of transferred employees were protected; the option of switching to an EDS designed pension scheme was also made available. Finally, EDS was liable for making severance payments to employees no longer required following the transfer.

The contract specifies that EDS must reduce the cost of the original work volume transferred from ITO by 35 percent over the term of the ten year contract. Payments to EDS are based on how far in advance IR places an order for a service with the price of services increasing as the difference between order and desired delivery date decreases. All payments are based on the original volume of work pricing mechanism. EDS profits in excess of a specified threshold are shared between EDS and IR. The payment scheme provides incentives to EDS to produce its services efficiently and also provides IR with the incentive to diligently plan its needs so that it can benefit from the tiered pricing mechanism.

The agreement created a series of committees and working groups with personnel from both agencies to ensure that the long-term as well as day-to-day terms of the contract are being met. This arrangement includes quarterly reviews of the risk allocation of the project.

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172 See note 107.
Given the dynamic nature of taxation legislation a key feature of this partnership is the commissioning of new work from EDS. At the time of the contract negotiation it was thought that the work being carried out by EDS at the end of the contract term would be vastly different from the initial activities. From 1994 to 2000, close to 400 different new projects were approved to be delivered by EDS. This required IR to develop a procedure for commissioning new work. The procedure involves divisions within IR and EDS identifying IT needs. EDS proposes solutions which are evaluated by IR for: (1) value for money; and (2) the potential for IR to get “locked-in” EDS technology. In some cases of new work IR’s project specification was incomplete. For one project the work necessary for completion increased by 93 percent because of IR’s omission of an application requirement, highlighting the difficulties of effectively managing private sector delivery arrangements. IR has attempted to limit such problems by developing “rapid application development” where the users of software in IR work with the developers at EDS on projects. It is felt that this will not only decrease the chance of misspecification but also expedite the completion of projects.
II. Social Services

A. Ontario

The Ministry of Community, Family, and Children’s Services (MCFCS) is responsible for child welfare services in Ontario. For decades, child welfare services have been delivered by the non-profit Children’s Aid Society (CAS). The MCFCS currently provides 100 percent of program funding for child welfare services to 53 local Children’s Aid Societies. Over the fiscal year ending March 31, 2000, an estimated 154,000 children from 86,000 families had made use of the services offered by the CAS. During the fiscal year ended March 31, 2002, $864 million of the $879 million spent on the program consisted of transfers to the CAS.

In the past, the program has been criticized because of a perceived lack of ability by the CAS to protect children. This occurred because, prior to 1998, there was no standardized procedure of child risk assessment. In response to this concern the MCFCS designed and implemented the Risk Assessment Model for Child Protection in Ontario in 1998. The model creates a standardized framework for evaluating child protection cases. However, the Ministry does not have a procedure for monitoring whether Societies are following the framework. In 2000, reviews of a sample of case files from regional offices found that half the protection investigation files that had been closed contained evidence that further examination should have been carried out. It was further noted that the Ministry lacked a process for monitoring whether plans for protective action for children at risk was completed in a reasonable amount of time and subsequently implemented. In light of these findings the Ministry announced its intentions to conduct annual reviews of child protection cases. This case illustrates the monitoring problem faced by governments for services where outcomes are particularly difficult to measure. Given the length of time CAS has been delivering services, the fact that a standardized risk assessment model and monitoring program have only recently been developed indicates the severity of the incentive problems existing within government. If a more collaborative approach had been fostered early on to clearly communicate the goals and desired outcomes of child welfare services, recent difficulties may have been avoided.

The Ministry proposed a new funding mechanism in 1998. The new formula bases funding on type and volume of service provided. The framework allocates funding according to residential care (group home and foster care), direct service costs (staff salaries), and indirect costs (administrative costs) and is based primarily on caseload. The Ministry conducted a review of caseload data for all 53 Societies in 1999. The review revealed that two thirds of Societies had unreliable non-residential data. Data tended to overestimate caseloads, resulting in excess funding.

Societies are now required to submit quarterly reports that indicate the difference between actual and budgeted expenditure as well as caseload data. The 1999 review observed that three quarters of reports were received after the due date and that many lacked the detail necessary to conduct an effective evaluation. It was also found that Ministry staff did not assess or pursue cases in which significant variance between actual and budgeted expenditure occurred. The Ministry responded by creating a new quarterly report format that requires that expenditures be identified by a project code.

Again, this raises the concern about the public service lacking the incentives, expertise and resources necessary to effectively manage its relationships with the private sector even when it has established a procedure to monitor the arrangement. The many reporting requirements also appear to be a step towards bureaucratizing the CAS which could lower the effectiveness of service delivery.

B. New Brunswick

The pursuit of a public-private partnership for adult literacy in New Brunswick was in response to 1986 provincial census data revealing that the province had an illiteracy rate of 26 percent. The only adult literacy training offered at the time was through community colleges. This system suffered inaccessibility, low attendance, and a high drop-out rate. The poor results of the status quo and the desire to maintain economic competitiveness, enhance quality of life, and have an educated citizenry, motivated the government to consider innovative methods of program delivery.

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In 1991, after consultation with various stakeholders the provincial government created Literacy New Brunswick Inc. (LNBI). LNBI is entrusted by the Government of New Brunswick with delivering the Community Academic Services Program (CASP). The mission of LNBI as articulated by the government is:

To marshall the full resources of New Brunswick to eliminate illiteracy by bringing learning to the people through partnerships with government, communities, the voluntary and the private sector.

LNBI is a non-profit organization with a board of directors entirely composed of individuals from the private sector. The members of the board are from both for-profit and non-profit institutions. The LNBI board decides LNBI’s strategy to implement its mandate; the provincial government does dictate how LNBI should achieve its objectives.

Since 1991, there have been over 1700 CASPs created providing instruction in English and French for grades 1 through 9 in 141 communities across the province. A program costs $16 752 for a 40-week (600 hours) course and teaches up to 20 adults. Students are not charged for attending the program. Funding is split between LNBI (82 percent) and the community (18 percent). LNBI funding comes from the Provincial Government of New Brunswick (69 percent) and the private sector (31 percent).

The program’s schedule is set by the students, creating a more flexible schedule that enhances accessibility. Further flexibility in the program was provided by the government exempting CASP instructors from the requirement of possessing formal teaching credentials. Enrollment in literacy programs has increased from hundreds in the community college programs to thousands participating in CASPs. At the same time, drop-out rates have fallen from 50 percent to seven percent. The CASP has a standardized curriculum designed by the New Brunswick Community College, as well as standardized testing. The community colleges conduct pre- and post-course testing to monitor results. Approximately 80 percent of students pass the standardized tests.

In order to keep costs down, CASPs are routinely conducted in rent-free locations such as church basements and community centres. The costs of instruction per student have decreased from $6.35 per hour in the community college setting to between $1.22 and $1.81 in the CASP, illustrating the innovative abilities of private sector agents to control costs when operating with scarce resources.
LNBI stands as a model of the gains made possible through the government, community, and the for- and non-profit sectors partnering with each other. The shared funding of the program provides an incentive for all to cooperate in order to maintain a successful program that provides the province with a more educated, employable, and competitive workforce. The existence of strong support for the program has been made abundantly clear: CASPs have in excess of 1000 volunteers and over 1500 funding partners. LNBI has won numerous accolades for the CASP including awards from UNESCO, the Conference Board of Canada, and IPAC.
III. Correctional Services

A. Ontario

In 1996, following discussions with external consultants, the Ministry of Correctional Services decided to build two new adult correctional facilities in Penetanguishene and Lindsay. Construction of the facilities was financed by the Ministry at a total cost of $87 million and completed in April 2001. While the facilities were being built the Ministry decided to contract-out the operation of the Penetanguishene jail making it the first privately operated adult correctional facility in Canada.

In 2000, a two-stage competition (i.e. an RFQ followed by an RFP) for the operation of the Penetanguishene facility was held. The Ministry of Correctional Services announced on May 5, 2001, that the Central North Correctional Centre in Penetanguishene would be operated and maintained by Management & Training Corporation of Utah (MTC) for a five year term.

The contract specifies a maximum operating cost of $79.45 per inmate per day. At the time of the signing of the agreement provincially-run jails cost an average of approximately $140 per adult inmate per day. All staff at the prison must meet Ministry training standards. The total operating costs of the Penetanguishene facility will be compared to the provincially-run Lindsay facility at the conclusion of the contract.

The Ministry has a full-time (24 hours a day, seven days a week) on-site monitoring team at the Penetanguishene facility to ensure that the private operator complies with the terms of the agreement. This is not likely to be the most efficient performance monitoring framework. Other jurisdictions (see the United Kingdom below) use a combination of unannounced and announced inspections to enforce contract compliance. Such an arrangement is a cost effective alternative to fulltime monitoring.

The provincial auditor noted that the Ministry originally intended one of the new prison facilities to be a build-own-operate PPP. Despite meeting with private sector consortia that expressed interest in financing and owning the prisons, the Ministry claimed that time constraints prevented it from using a PPP. The Ministry also argued that the higher cost of private finance discouraged the use of a PPP (the problems with this argument are described above). However,

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175 This section is based on: Ontario, Ministry of Correctional Services, 2001-2002 Business Plan, (Queen’s Printer for Ontario, 2001); Office of the Provincial Auditor (2000).
the Ministry did not conduct any cost-benefit analysis comparing the differences between government and private ownership. The provincial auditor commented that the Ministry’s “choice of financing and ownership was not based on a sound business case.” If proper analysis was conducted is may have concluded that private finance was the most efficient procurement option.

The Ministry also stated that potential private partners were more interested in operating the prison than in financing the institution. However, such reasons ignore the incentives to comply with a contract that private ownership of the facility would yield. Under a PPP, with private ownership, the incentives to comply with contract requirements would be much stronger since the private firm would be left with the sunk cost of building the prison in the event of contract termination resulting from violating the service agreement. Thus, a PPP arrangement would not likely require the full-time monitoring program that the Ministry has decided to use for its contracting-out agreement. The potential loss of efficiency gains from the failure to use a PPP illustrates that arrangements between the private sector and government require a skilled acquisition workforce within the public sector with incentives to select the most suitable procurement option.

B. United Kingdom

In 1992, the UK Prison Service recognized the need for new prisons in South Wales. The Prison Service determined that a prison with the capacity for 800 prisoners was required to meet current and future needs. The new prison would be built in Bridgend, South Wales. Through the hiring of outside consultants it was determined that a PPP offered the best value for money and that the Prison Service lacked the funds necessary for construction. Therefore, a PFI agreement engaging a private partner to design, build, finance and operate (DBFO) the prison for a 25 year period was selected. The Bridgend (now Parc) Prison was the first DBFO prison project in the UK.

In 1993, the Prison Services published a notice inviting private sector agents to express interest in the project, receiving 60 responses. A conference explaining the project to prospective bidders was held later in the year. Following the conference, bidders were encouraged to submit...
anonymous written questions to Prison Services regarding the project (10 firms and consortia replied). Both the questions and answers were circulated to all bidders.

In July 1994, an invitation to tender was issued to six consortia. The tender provided documentation regarding: (1) the services required; (2) an outline of the main terms and conditions of the contract; and (3) the factors used for evaluating bids. While the services required were given in the tender, no specifications regarding how the prison should be constructed were given. Bids were evaluated in four areas: deliverability, financial, quality, and innovation. In January 1996, a contract was awarded to the Securicor/Costain consortium.

The Bridgend project is a DBFO PPP for a 25 year term. At the end of the term the prison reverts to state ownership. The contract sets out the allocation of risks between Prison Services and the consortium. The risks of time and cost overruns during the construction period, prisoner well being and security, and prison maintenance were allocated to the contractors. Operating cost risks were shared between both parties. Originally, Prison Services proposed to pay the contractors on an occupancy basis because shifting occupancy risk to bidders would be the least costly option for the government. Bidders refused to accept such an allocation of risks pointing out that Prison Services should assume the associated risks because it controlled the allocation of prisoners between prisons. This disagreement resulted in none of the initial bids complying with the original tender document.

It was eventually agreed that payment would be based primarily on construction and operation costs with adjustments made for both economy wide and industry specific inflation, as well as changes in costs beyond the control of the consortium, such as changes in legislation. This resulted in a new tender being issued in February 1995. This delay led to an increase in cost to Prison Services of hiring expert advisers and consultants for the project to £1.6 million; these services were originally budgeted for £0.6 million.

The risk allocation disagreement and subsequent delay of project implementation and cost increases indicates the importance of project management. It also indicates that discussion with potential partners prior to the bidding process is a valuable enterprise for governments to

177 Three of the bidders had overseas partners.
179 For the details of the risk allocation see: Ibid., pp. 71-73.
180 For complete description see: Ibid., p. 74-75.
undertake. The conflict also illustrates that a hard “bottom-line” approach to service delivery by
government is not necessarily the most constructive way to engage the private sector.

An additional condition in the tender allowed for a payment reduction by Prison Services
if the consortium’s actual rate of return is higher than that estimated at the time of contract
finalization. Other terms of payment included the condition that the consortium would not be
paid until the prison was completed and ready to be occupied. Further, the failure to meet
performance standards and maintenance requirements would lead to a reduction in payments and
possible contract termination. Lastly, all employees working at the prison are required to
complete an eight week training program approved by Prison Services. This arrangement was an
attempt to alleviate concerns of the public that private sector employees would lack the necessary
training to safely operate the prison.

With an expected design and construction time frame of 40 months the Parc Prison was
estimated to be operational 35 months earlier than the average prison built with traditional
procurement methods. The prison opened in November 1997, one month ahead of schedule. The
speed of construction indicates how a proper payment structure is integral to providing
incentives for efficient service delivery. It also illustrates the strength of the ownership effect in
encouraging efficient behaviour. A portion of these time savings are being credited to the
bundling of the design and construction features of the project (it was estimated that separate
tender offers for design and construction would have delayed completion by three to four
months). Cost savings from the initiative are estimated to be 10 percent over traditional
procurement methods (this includes the case of public financing of construction with private
sector operation).

The National Audit Office (NAO) recommended that for future procurement projects the
Prison Service should request bidders to breakdown their aggregate bid into the various project
components, such as the costs associated with design, construction and financing. The Prison
Service has refined its methods of PFI projects significantly since the initial project. It required
17 months from the invitation to tender to final awarding of the contract in the Bridgend case. In
1996, the partner selection process for the DOFB PFI for the Lowdham Grange prison was
completed in six months.
The NAO conducted on the operational performance of private prisons versus public prisons.\textsuperscript{181} The study found the performance of privately owned and operated prisons mixed. The best private owned and operated prisons outperformed most public prisons and the worst private prisons ranking with the poorest public prisons.\textsuperscript{182} The study also notes that evidence suggests that competition from the private sector has improved the operations of the Prison Service, such as introducing competition in the management of prisons.\textsuperscript{183}

\textbf{C. United States}\textsuperscript{184}

The United States has the most experience of any country in the world in contracting-out prison services. In 2001, 158 of the world’s 184 privately operated correctional facilities were located in the United States. These private facilities housed 52,370 of the 1.2 million prisoner population of the United States. The need for private prisons was motivated by a more than doubling of the country’s prison and jail populations from 750,000 in 1985 to 1.7 million in 1997, resulting in a shortage of prison space in many jurisdictions. For example, in Oklahoma, the lack of prison capacity was so acute that court-condemned cellhouses were reopened to house the prison population while other prisoners were sent to facilities in Texas. As a result, private sector involvement was sought.

As observed in the United Kingdom, the United States reveals that the ownership effect can be an extremely powerful in eliciting efficient performance in the construction of facilities. For example, the Corrections Corporation of America (CCA) was contracted to build and operate a detention centre in Texas for the U.S. Immigration and Naturalization Service (INS). The INS estimated that the construction of the facility would take 2.5 years to complete at a cost of US$26,000 per bed. The facility was completed by CCA in 5.5 months at a cost of US$14,000 per bed. However, while the cost and speed of construction of facilities has been shown to be superior when carried out by the private sector, the evidence with respect to operating costs is rather ambiguous.

\textsuperscript{181} NAO, \textit{The Operational Performance of PFI Prisons}, (June 2003).
\textsuperscript{182} Ibid.
\textsuperscript{183} Ibid.
\textsuperscript{184} This section is based on: James Austin and Garry Coventry, \textit{Emerging Issues on Privatized Prisons}, (U.S. Department of Justice, Bureau of Justice Assistance: February 2001); and GAO, \textit{Private and Public Prisons: Studies Comparing Operational Costs and/or Quality of Service}, (August 1996).
In an attempt to assess the impact of private sector involvement, the GAO reviewed a series of studies on privatized and privately-operated correctional facilities in 1996. The five studies examined by the GAO were conducted in Texas, New Mexico, California, Tennessee and Washington. The Texas study concluded that privately operated prisons experienced cost savings of 14-15 percent over publicly operated prisons. However, the GAO noted that the Texas study generated costs for hypothetical publicly operated facilities because comparable publicly run institutions did not exist. The California study compared a privately managed correctional facility with two publicly managed ones. It calculated that the costs of the privately managed institution fell between the two publicly managed facilities. The Tennessee study found that the costs of the private and public facilities were virtually identical. The Washington study examined the same facilities as the Tennessee study and found that the costs of the private facility were slightly lower than the public institutions. The Washington study also examined two private and one state-run facility in Louisiana and found the costs to be virtually identical. The inability to conclude whether cost differences exist between privately- or publicly-run may be the result of a competition occurring between the private and public sector as both sectors compete for prisoners in order to remain in operation.

Additionally, the Washington study examined the quality of service in Tennessee, Louisiana, and two state prisons in Washington. It found that the quality of service for all the prisons were similar. The New Mexico study examined quality of service for a privately- and a state-run prison in New Mexico and a federal prison in West Virginia. The study found that staff strongly favoured the private facility while inmates strongly favoured one of the public facilities.

In terms of the process of selecting a private partner for the delivery of prison services, Oklahoma presents an excellent model. Firms must apply to become a private prison contractor in the state. In order to become a contractor a firm must provide detailed information including: the qualifications of key staff, identifying any subcontractors that will be used to provide prison services, annual audit results and financial statements for the last two years that have been evaluated by a certified public accountant, and a list of past and present contract work performed for Oklahoma and other jurisdictions. Only a qualified contractor may submit a proposal when the Department of Corrections (DOC) issues an RFP for inmate housing. The

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185 See GAO (1996).
186 For further details see Oklahoma’s Department of Corrections (DOC) private prisons website at: [http://www.doc.state.ok.us/](http://www.doc.state.ok.us/)
RFP contains a detailed description of the expectations of the DOC regarding personnel, training, security and emergency procedures, medical care, etc.

The state has a standardized correctional services contract. The contract provides details regarding the maintenance, operations, and services of the facility, and conditions and remedies in the event of contract breach by the state or the owner/operator. In the event of a breach of contract the state is entitled to withhold payment from a contractor. To ensure contract compliance the DOC has contract monitors assigned to every private prison. The monitors spend three to four days a week at the facility to ensure that the terms of the contract are being performed. These monitors provide weekly and monthly, and quarterly reports, as well as an annual audit on facility operations. The DOC requires contract monitors to possess extensive knowledge in the field of correctional services: Oklahoma’s prison monitors have an average of 19 years of experience in the field. The DOC has created a guide for contract monitors that provides detailed instructions regarding monitoring procedures and checklists for reports. In 2001, the private prisons in Oklahoma received performance evaluations ranging from 88 percent to 98 percent compliant. Two prisons were assessed US$85,975 in damages for contract breaches in 2001.
IV. Highways

A. Ontario

Highway 407 Electronic Toll Route (ETR)\textsuperscript{187}

Highway 407 ETR runs along the northern and western perimeter of the Greater Toronto Area (GTA). The highway was deemed necessary to relieve traffic congestion in the GTA. It was estimated that congestion on existing highways was costing the economy $2 billion in lost productivity a year. The Ontario Transportation Capital Corporation (OTCC), a Crown corporation was created to implement the new highway plan.

In May 1993, RFQs were sent by the Ministry of Transportation (MTO) to two consortia to finance, design, build, and operate Highway 407 as a toll road. The operation term was for a 30 year period, at which point the highway would be handed over to the province. The provincial government’s desire to have the project privately financed was abandoned early in the bidding process due to a perceived excessive premium demanded by the private sector bidders. As a result, the province decided to fund the construction of the project entirely by itself. It should be noted that only two firms were invited to bid for the project because the government wished to award the contract to a company based in Ontario. A more competitive bidding process, leading to a more efficiently designed highway may have resulted without such a restriction. Indeed, the introduction of foreign firms may have led to an acceptable bid that allowed for private financing of the project.

The Ministry paid the consortia $1.5 million each to develop “value engineering assessment reports,” (VEAR) expressing the consortia’s ideas regarding cost-effective ways to design and build the roadway. Based on the VEARs the Ministry selected a base design and issued an RFP to the two consortia in September 1993. The RFP was broad and did not specify how many lanes the new highway should be. The proposals were evaluated in the following pre-determined areas: business and finance; risk assessment; provincial fiscal impact; toll regulations; industrial benefits; and engineering.

The government awarded the design-build portion to the Canadian Highways International Corp. consortium with a $930 million fixed-price contract. The construction design

\textsuperscript{187} This section is based on Office of the Provincial Auditor, \textit{1996 Annual Report}, (Queen’s Printer for Ontario: 1996); Daniels and Trebilcock (1996).
proposed a four to six land highway that could later be expanded to eight lanes. The OTCC financed the construction portion of the contract through issuing debt that would be paid for by the tolls collected when the highway was completed. Under the traditional delivery scheme of a non-toll roadway and government financing the construction of Highway 407 would have taken approximately 20 years. However, by making Highway 407 a toll road, the government was able to reduce the construction time to 4.5 years through issuing debt.

It is estimated that the winning construction design produced savings of $300 million over the MTO’s design. Much of the savings was generated by eliminating or delaying the construction of nine planned interchanges that the winning consortium did not consider necessary at the time of construction. The first 36 km section of the highway was opened in 1996 and the remaining 13 km opening in 1997. The winning consortium’s initial proposal estimated that construction would be completed in 1999.

Performance of construction was monitored by an independent engineering consulting firm hired by the MTO. The consulting firm was made responsible for approving the design and construction activities of the winning consortium. The budget for monitoring was set at one half of one percent of the highway’s total cost, significantly below the average cost of 8-10 percent for ministry contracts. Thus, Highway 407 ETR illustrates that contracting-out monitoring activities can yield significant savings to governments.

The tolling system was awarded to the tolling component of the losing consortium for $102 million. The toll design proposed a fully electronic tolling system. The design made Highway 407 ETR the first fully electronic open-access toll road in the world. The tolls are based on vehicle type and distance traveled. Vehicle information is registered through a transponder located in drivers’ vehicles with no physical toll collecting stations. Vehicles that lack transponders are charged via digital photographs taken while entering and exiting the highway. The Government of Ontario made arrangements with eight of the other nine Canadian provinces and with nearby U.S. states in order to acquire information to bill non-Ontario motorists.

This partnership arrangement was dissolved in 1998 when the Government of Ontario announced that it would privatize Highway 407. In 1999, the roadway was leased to a private consortium for a 99-year term. The private owner has completed eastern and western extensions of the highway to bring its total length to 109 km.
The condition of Ontario’s highways has varied greatly over the years. In 1979, over 60 percent of the province’s network was deemed to be in good condition. By 1991, lack of maintenance led to only 40 percent being in good condition; in 1998, 44 percent of the network met the criteria. In 1999, approximately 30 percent of road system maintenance in Ontario was contracted out. By 2001, maintenance for the entire road system had been contracted out. The conditions of the system as well as potential cost savings were the motivating factors in outsourcing maintenance of the province’s highways.

The MTO conducted a cost/benefit analysis and risk assessment for three models of outsourcing in 1996. The models, from high to low Ministry oversight, were managed outsourcing contracts (MO), area maintenance contracts (AMC), and area term contracts (ATC). Analysis by the Ministry determined that MOs and AMCs offered savings. The Ministry initially tendered AMC contracts. In order to ensure a competitive bidding process the Ministry limited the size of individual contracts. However, the Ministry allowed contractors to make one bid on a bundle of contracts comprising a single maintenance region and did not put an upper limit on the number of contracts any firm could win.

The Ministry’s chose contractors using a two-stage competition, an RFQ followed by an RFP. The bids were rated by a scoring process. Contractors had to receive a minimum score in order to advance to the next round of bidding. Further, a minimum overall score was necessary to award a contract. In 1999, an examination by the provincial auditor determined that the Ministry’s selection process to select highway maintenance contractors was appropriate.

By 1999, the Ministry estimated that the contracts led to savings of 5.2 percent over publicly provided maintenance. However, the provincial auditor’s examination of four AMC contracts found an estimated saving of only 0.3 percent; almost all savings were estimated to be one-time savings. This led the provincial auditor to conclude that outsourcing may be the more expensive method of delivery and that the savings generated by the government’s estimates were a product of its accounting procedure. This experience underscores the need for detailed analysis of the benefits and costs of engaging the private sector to be conducted by government and to be

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made available for public scrutiny. Without such measures, conflicting reports regarding the results of private sector delivery will undermine the public’s willingness to allow such arrangements to be pursued in the future.

There have been problems associated with the monitoring of maintenance activities. The Ministry assigns area maintenance coordinators to inspect maintenance work. Coordinators have stated to the Provincial Auditor that monitoring areas were too large and that their staff was too small to effectively monitor contractors. Secondly, it was found that monitors did not keep comprehensive records of their findings. Also, it was found that even though contracts contained penalties, in the form of damages for non-performance, maintenance coordinators often did not issue penalties and did not record how contract violations were settled. Finally, the province relies on contractors to report maintenance activities to its database; however, in 2001 the Ministry lacked a procedure for verifying the accuracy of these reports.

Technological advance appears to be the best method to improve performance monitoring. In an attempt to improve the monitoring of areas, the Ministry committed to start a pilot project during the 2000/01 fiscal year making use of Global Positioning System (GPS) technology to monitor the location of both contractor and ministry vehicles and equipment. The Ministry has also installed sensors on vehicles to record speed, direction, and the rate of salt and sand dispersal. Finally, the Ministry is developing a detailed computerized “Performance Rating System” to monitor a contractor’s historical performance that can be used in evaluating contract renewal and/or future bids. The reliance on technology indicates that it may be advisable for the government to engage a private sector firm to work exclusively on the development of technology for performance monitoring.

B. Mexico

The Mexican government began to pursue private finance in the construction and operation of toll roads in 1987 under the National Program of Concessioned Toll Roads (NPCT). The NPCT was designed to foster the development of 5300 km of modern highways. The first

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concession awarded to a private firm occurred in 1989. Contracts were awarded to the firms requiring the shortest concession term to recoup their investment given an established toll rate. Private firms would construct, operate, maintain and receive toll income from the highway. The tolls were set by the Ministry of Communications and Transportation and were to be constant in real terms over time. The Secretary of Communications and Transport (SCT) guaranteed a minimal level of traffic volume for which the firms would receive payment. If traffic volume fell below the guaranteed level the concession term could be extended to allow firms more time to recoup their investment. The concession winner was responsible for cost overruns of up to 15 percent over the estimated costs of highway construction.

The NPCT was a disaster. Total investment was 29 per cent higher, in real terms, than stated in the original contracts. Construction time was 55 percent longer than initially agreed upon. The average construction cost per kilometer of road rose from US$1.7 million to roughly US$2.6 million to US$2.8 million. Both traffic and toll revenues were lower than expected.

The low toll revenues were the result of not conducting an estimate of the elasticity of demand of drivers with respect to tolls. Tolls were set extremely high in order to yield a shorter concession term; however, the trade-off between toll levels and traffic levels was never considered in designing the NPCT. As a result many motorists continued using the existing non-toll roads.

Part of the poor results of the project can be attributed to the 1995 economic downturn in the Mexican economy, but most are due to a severely inadequate procurement process. Firstly, bidders were not required to provide a financing plan as part of their bid. Secondly, the Mexican Law on Acquisitions and Public Works prevented firms awarded the design component of a project from winning the construction component. This prohibition on bundling led to design misspecification: highways for which freight traffic was predominant had been designed for automobile traffic. Thirdly, potential bidders were constrained to use local construction firms. Fourthly, payment to successful bidders was partly based on the size of their investment, creating an incentive to over-invest in the construction of the new roads.

The procurement process led to speculation that the real purpose of the NPCT was to subsidize Mexico’s construction industry, leading winning bidders to be confident that the government would bail-out failing projects. Evidence suggests that this theory is cannot be dismissed easily. The Mexican government gave financial support to distressed road operators
and extended concession terms. Concession terms were extended to half the concessions granted (26 out of 53) and concession terms were extended from an average of 16.5 years to 23 years. Initially, the legal maximum concession term was 20 years. In 1997, 23 of the 52 concession were transferred back to the state, resulting in the government assuming approximately US$4.8 billion in debt.

**C. Scotland**

The Scottish Office Development Department hired consultants to examine the feasibility of privately financing improvements to the A74(M)/M74 motorway. The study considered both two and three lane motorways, concluding that a three lane motorway was the best choice. A detailed cost-benefit analysis was conducted in order to arrive at this conclusion. The analysis consisted of examining the cost of construction and operation, time savings based on type of journey and vehicle (light and heavy), maintenance of traffic flow, vehicle operation costs and accident costs. The study concluded that a privately financed project would cost £17 million less than the publicly funded alternative.

An expression of interest was issued for a DBFO contract for the motorway. Four out of the six consortia that expressed an interest in the project were invited to bid on the contract. The tender included all relevant information regarding the laws governing the project, standards for operation and maintenance, and payment method. Decisions relating to materials, route, incline, and decline were left to bidders. Bidders were asked to propose “shadow tolls” based on specified levels of traffic risk to permit better comparisons. “Shadow toll” are payments made by the government to the winning consortium based on the usage and performance of the road built; motorists do no pay tolls. Bidders also submitted a separate shadow toll based on their desired level of risk allocation.

Because all bids met the tender specifications, the Development Department felt that choosing the lowest bid (lowest present value of shadow tolls paid) would provide the best “value for money.” However, instead of picking the lowest of the four bids received, two firms were selected to make a final bid after the department had negotiated final contracts with the parties. This additional round of bidding was not initially planned to occur and led the cost of the

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190 This section is based on: NAO, *The Private Finance Initiative: The Contract to Complete and Operate the A74(M)/M74 Motorway in Scotland*, (April 1999).
procurement process to go over budget by £1.5 million and delayed project implementation by eight months. The firms chosen for the final round stated that they would not engage in such a bid again without reimbursement, illustrating the risks of creating uncertainty in the competition process. In 1996, the Autolink consortium was selected as the winning bidder.

The contract contains performance standards with penalties for poor performance (e.g. Autolink is charged for lane closures). The parties agreed that performance would be monitored through an independent overseer selected by Autolink and approved by the Development Department. The overseer would report to the Department. The contract provides for flexibility in the terms if the service specification changes. At the end of the contract ownership of the motorway reverts back to the government. The contract specifies that the Department should not need to resurface the road for 10 years following the transfer.

The Department expected the road to be completed in three years, Autolink’s bid estimated it would take 2 years and 4 months. Ultimately, the motorway was completed almost two months earlier than Autolink’s estimate. This speed can be attributed to the payment structure that only provides compensation when the facility is functional. In addition to completing the motorway ahead of schedule, Autolink used a new surfacing material that would lower road noise, had better drainage, and yield a longer lifespan than regular pavement. This innovation indicates the value of allowing the private sector to decide on the inputs used for project delivery and that the role of the government is best suited to articulating the desired outcome.

It should be noted that privatization of the roadway may be the most efficient delivery arrangement. The “shadow toll” regime under the present partnership arrangement is not the most efficient pricing mechanism because tolls are paid by the government rather than by motorists. A better pricing system that would encourage efficient use of the roadway would directly charge motorists based on vehicle weight, time of travel, direction of travel, and number of passengers. Such an arrangement would most likely occur with privatization.

13. Conclusions

Private sector involvement in the delivery of essential and non-essential public services and projects has existed for many years and has proven to be effective when properly structured.

191 See Hrab (2003).
There is ample evidence indicating that the public sector is not as cost efficient as the private sector; however, there is much evidence indicating that the public sector lacks the incentive structure and expertise necessary to consistently develop and oversee efficient and effective private sector delivery arrangements. The evidence observed in Ontario and other jurisdictions indicates that creating incentives to foster such expertise within the public sector is an elusive goal. The absence of the skills and incentives necessary to manage these projects within the public sector will lead to ventures with the private sector being poorly conceived and executed—a state of affairs that bodes ill for establishing the benefits of private sector involvement in service delivery. Ontario requires a framework that creates incentives for the public sector to effectively develop, implement and assess service delivery arrangements.

Developing appropriate relationships with the private sector requires the government to develop a standard, open, clear and predictable process for initiating, negotiating, monitoring, and evaluating arrangements with the private sector. This process must be designed to prevent inappropriate selection, and rejection, of private sector delivery arrangements, such as making procurement decisions for accounting purposes, unreflective ideological reasons, or using procurement as a form of subsidization. The process should establish a clear understanding between the public and stakeholders regarding goals and outcomes. It will be chiefly through this type of transparent process that government will be able to win widespread support for these service delivery arrangements. Without such support, more ambitious welfare improving projects may not be feasible.

It should be recalled that these alternative delivery arrangements are not always appropriate. When contractual arrangements between the public and private sector cannot be designed and monitored in an effective manner continued public delivery could be the most appropriate delivery option. In other cases, serving the public interest could best be accomplished through complete privatization rather than alternative delivery arrangements, such as PPPs and outsourcing.

Ontario has experienced mixed outcomes with private sector delivery arrangements. The province’s use of large scale PPPs has been extremely limited. The province needs to develop a standard and integrated process of procurement for project selection, risk allocation, and performance monitoring to reap the full benefits of private sector delivery options. This process needs to be transparent and open in order to gain legitimacy in the eyes of both the public and
private sector and other stakeholders. The results of SuperBuild indicate the need for Ontario to improve its approach to involving the private sector in the delivery of public services. The current environment in Ontario also reveals a need to pay closer attention to labour issues and develop a more collaborative approach to building support for ASD initiatives. The current adversarial relationship between the public sector unions and the government is decreasing the benefits of such arrangements. Continued hostilities and the associated costs may deter the private sector from participating in large-scale projects.

Ontario needs a common and integrated procurement framework, incorporating ASD considerations, including privatization, to be applied across all ministries and agencies. Effective project management requires undertaking substantial analysis, consultation and oversight throughout a project’s lifecycle. There is much knowledge to be gained from observing the experiences of other jurisdictions instituting alternative delivery mechanisms. The United Kingdom’s Gateway Review presents a model for Ontario. Ontario could implement, for example, a review process whereby all outsourcing and PPP initiatives in excess of, for example, $200,000, would be reviewed by a new independent procurement oversight agency for adherence to a common procurement framework. The results of the agency’s reviews should be published and made publicly available. The ministry or agency involved in the reviewed project should be identified in the reviewer’s report. Similar assessments, with the reviewing agency possibly possessing the authority to halt a troubled project, would occur throughout a project’s lifecycle. Such a review process should provide better measurement of performance regarding the design, development and implementation of procurement initiatives by government ministries and agencies.
14. References


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