Competitiveness and contracting out of local authorities’ services

1. The decision to ‘make or buy’ goods and services is among the most important facing any commercial or industrial undertaking. One of the keys to success of many Japanese businesses has been the close relationship that they have established with, literally, thousands of independent suppliers; exactly the same applies to Marks and Spencer and other leading multiple retailers in the United Kingdom. In every case, a successful relationship allows both the supplier and the customer to benefit; and in many cases, the design of the final product is influenced by the cost structure and production methods of the component suppliers. Marks and Spencer even install their own quality assurance procedures – and sometimes people as well – in suppliers’ plants.

“Every year authorities spend some £3 billion on bought-in goods or services ...”

2. Local authorities face precisely similar choices between providing services directly or buying them in from outside suppliers. This is nothing new. Every year, authorities spend some £3 billion on bought-in goods or services covering an extraordinarily wide range – from architectural services to pencils for use in schools.

3. The opportunity for local authorities, as major buyers of goods and services, is immense. Purchasing power should be used constructively to improve competitiveness and to encourage new management approaches within supplying organisations. The result could be improved service at lower cost – because successful competitors will be less wasteful of resources than their would-be rivals. This Occasional Paper, therefore, summarises the evidence from the Commission’s earlier studies and auditors’ experience of the potential for increased competitiveness within local authorities’ services. It goes on to identify some of the strategic issues to be addressed by management when deciding whether to provide a service directly or to buy it, and what should be the criteria for competition for local authorities. Other Occasional Papers will follow, as material emerging from the Commission’s studies warrants.
Potential benefits from enhanced competitiveness

5. The Commission has examined three services where private sector suppliers and Direct Labour Organisations compete with each other: refuse collection, vehicle maintenance, and repairs and improvements to council houses. In each case, the evidence is irrefutable that:
(a) Costs incurred by ratepayers are higher if services are not subject to competition
(b) Major cost savings would result if all local authorities were able to obtain services at the costs already secured by the most successful 25% of authorities
(c) The most competitive DLOs have costs that are lower than the prices quoted by the average private suppliers; but an average DLO’s costs are more expensive to ratepayers than private suppliers. That is, most DLOs are not fully cost competitive.

Table 1 summarises the potential value improvements, if all authorities matched current ‘best quartile’ performance, based on the evidence currently available to the Commission.

The rest of this section covers each of these services in turn.

Housing maintenance

6. As the Commission’s recent report, Improving Council House Maintenance shows, works costs associated with planned and responsive maintenance amount to some £170 a year per dwelling – implying total annual expenditure of £1,775 million. Over half this work is carried out by Direct Labour Organisations.

7. There are two ways to judge the potential for value improvement from increased competitiveness: comparing prices for the same ‘basket’ of jobs based on authorities’ schedules of rates, and comparing prices for the most common jobbing repairs. The analysis has been computed for 40 schedules of rates and data has been obtained from 22 authorities on the costs of common jobbing repairs. The results are shown in the report referred to earlier, and are summarised in Table 2. In each case, because the costs in London are invariably higher, these have not been included.

Table 1: POTENTIAL ANNUAL VALUE IMPROVEMENTS MATCHING BEST QUARTILE PERFORMANCE

<table>
<thead>
<tr>
<th></th>
<th>£ million at current prices</th>
<th>%</th>
<th>Memo: Sample size (Number of authorities)</th>
</tr>
</thead>
<tbody>
<tr>
<td>House maintenance</td>
<td>350</td>
<td>20</td>
<td>40</td>
</tr>
<tr>
<td>Vehicle management</td>
<td>85</td>
<td>25</td>
<td>227</td>
</tr>
<tr>
<td>Refuse collection</td>
<td>30</td>
<td>15</td>
<td>336</td>
</tr>
<tr>
<td>Total</td>
<td>510</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Exhibit 1 shows the situation for trade models more precisely. The conclusion is inescapable. If the sample is representative – and there is no reason to believe that it understates the potential because London is excluded – the potential gain if all authorities matched first quartile performance will be of the order of 20%.

8. Detailed analysis shows that costs tend to be higher when work is not subject to competition. For example:
- Costs of re-wiring varied between £218 and £196 per dwelling for trade contractors; the cost for work not subject to competition averaged about £600 per dwelling

Exhibit 1

TRADE MODELS: CARPENTRY AND PLUMBING
1984-5 Schedules of Rates

Table 2: DIFFERENCES BETWEEN FIRST QUARTILE AND MEDIAN COSTS (%)

<table>
<thead>
<tr>
<th>Trade model analysis of schedules of rates</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>- Carpentry</td>
<td>- 23%</td>
</tr>
<tr>
<td>- Plumbing</td>
<td>- 20</td>
</tr>
<tr>
<td>- Bricklaying</td>
<td>- 18</td>
</tr>
<tr>
<td>- Roofing</td>
<td>- 26</td>
</tr>
<tr>
<td>Average (weighted)</td>
<td>- 20</td>
</tr>
</tbody>
</table>

- One DLO was charging over £2,000 per dwelling for roof tiling, compared with £800-1,200 for similar work let on a competitive contract in a nearby authority.
- A number of authorities have put contracts for servicing heating and hot water installations out to tender. Private contractors have won maintenance contracts from the local Gas Boards at considerably reduced prices.
- Tender prices, as reported by the Building Cost Information Service, vary very considerably outside London, by some 60% between the lowest and highest bid for any particular contract.

“The potential gain will be of the order of 20%”
Refuse collection

9. Refuse collection shows a similar pattern. As described in the Commission’s August 1984 report, Securing Further Improvements in Refuse Collection, during the first round of audits carried out after the Commission took up its responsibilities in early 1983, auditors applied the ROSS Audit package developed by LAMSAC in some 140 authorities in England and Wales. ROSS shows the target cost and staffing for a local refuse collection service, taking into account the desired standard of service (e.g. kerbside/wheeled bins; backdoor/sacks) and relevant local factors such as housing density, the average length of walk to and from the backdoor and so on. The model has been shown to be accurate to within ±2%.

10. As at July 1984, the analysis showed a wide spread in authorities’ performance against the ROSS standard, with one in five authorities performing 5% or better than ROSS; a third close to the standard and the balance 5% or more above the costs indicated by the ROSS model. Overall, the range was from nearly 20% better than ROSS to some 40% worse. Exhibit 2 provides the detailed results. Several points are worth noting:

- In July 1984, the average contracted out service was provided at a cost of around 5% below ROSS. So at that time, eight out of ten authorities would have benefited from contracting out their service. As at March 1986, only 24 authorities have in fact contracted out this particular service.
- The spread in costs was apparent after considerable productivity gains had been achieved. In the four years to December 1984, overall refuse collection staffing reduced by 18% (excluding the effects of privatisation) over a time when the volume of refuse to be collected was rising steadily.
- The total value improvements arising from the local audit projects amounted to some £22 million a year, as at the end of March 1986.

“... total value improvements arising from local audit projects amounted to some £22 million a year...”

11. Assuming that all the local improvements materialise, there remains potential for further gains. Specifically, if every authority matches the performance of the best 20% (and the average private contractor’s performance) it will be reasonable to anticipate further value improvements worth of the order of £30 million a year.

Exhibit 2

REFUSE COLLECTION COSTS:

<table>
<thead>
<tr>
<th>Over 5% better than ROSS</th>
<th>Close to ROSS</th>
<th>Over 5% worse than ROSS</th>
</tr>
</thead>
<tbody>
<tr>
<td>(19%)</td>
<td>(34%)</td>
<td>(47%)</td>
</tr>
</tbody>
</table>

No. of Authorities

Source: Audit Commission analysis of ROSS Audit results, July 1984

CHANGE IN REFUSE COLLECTION STAFFING — %

December 1984 vs December 1979, England only

Overall Staff Reduction in Non-privatised Services = 18%

<table>
<thead>
<tr>
<th>Inner London*</th>
<th>No Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Metropolitan Districts</td>
<td>-21%</td>
</tr>
<tr>
<td>Shire Districts</td>
<td>-22</td>
</tr>
<tr>
<td>Outer London</td>
<td>-25</td>
</tr>
<tr>
<td>Inner London**</td>
<td>-40</td>
</tr>
</tbody>
</table>

Overall 21%

* Excluding Hammersmith and Fulham, Kensington and Chelsea, Wandsworth and Westminster

** Hammersmith and Fulham, Kensington and Chelsea, Westminster

Source: LACSAB, Joint Manpower Watch statistics
Vehicle maintenance


13. Around 230 local projects were carried out, to follow up the Commission’s recommendations. These showed that, if anything, the potential savings were understated; many authorities were able to beat the ‘target’ of maintenance costs of £700 per (weighted) vehicle. Exhibit 3 shows the position for a sample of Shire districts – which tend, overall, to have lower maintenance costs than other authorities. The costs per (weighted) vehicle where maintenance is open to competition appears to be of the order of £450-500 per vehicle a year. If all authorities were to achieve £500 a year per vehicle, the saving would amount to £118 million, at 1983 prices.

“...many authorities were able to beat the ‘target’ of maintenance costs of £700 per (weighted) vehicle”

Strategic issues to be examined

14. It would be tempting to argue that the solution to a non-competitive DLO is to contract out the service. And this should certainly be one option to be considered. But it does not represent an appropriate universal prescription. There are some advantages to direct labour which should not be forgone unnecessarily; and there are some risks in depending exclusively on any single supplier for an important service. Indeed, the Commission believes that it is important to sound some general warnings:

(a) Privatisation will not necessarily secure competitiveness. It would be unwise to assume that the private sector is necessarily able to provide a comparable service at lower cost than every local DLO. In some instances this will be the case; in others, it will not. And privatising a service in total could result in replacement of a public monopoly with a private one unless authorities retain an in-house capability to ensure that contractors remain cost competitive.

(b) There are often good strategic reasons from a contractor’s point of view as to why bidding for local government work is not especially attractive in a number of situations:

- The emphasis is likely to be on cost, not value; so the opportunity to add extra value and to earn higher margins will be limited. As a result, profit margins are likely to be tight.
- There is no opportunity to build a pre-emptive local position; the contractor will always be vulnerable, since the contract will be regularly subject to competition and in most of the services concerned, entry barriers for competitors are low.
- Any performance shortfalls will attract immediate unfavourable publicity locally, and possibly nationally as well. This could easily have knock-on effects elsewhere within the contractor’s business. It is for this reason, for instance, that a number of leading companies have declined to bid on NHS catering contracts.
- The potential supplier may not have the local management or capital equipment in place to meet the authorities’ requirements. Some trade associations have made it clear that in their industry, capacity is limited and cannot be expanded quickly.

It would, therefore, be unwise to assume that there will invariably be suitably qualified contractors willing to bid for every local contract.

(c) Creative accounting and clumsy regulations have allowed DLOs to manage around the earlier legislation: the amount of work done by direct labour in the housing maintenance field has not reduced in real terms over the past five years, as the Commission’s report on housing maintenance shows. While one of the most notoriously inefficient DLOs in the country shows a 10% Current Cost Accounting (CCA) return on its assets – better than all but the most efficient private building concerns.

(d) Central overheads are likely to increase when work is put out to tender, because it will be necessary both to specify the work to be done in sufficient detail for the contractors to know what they are expected to do and also to monitor the contractors’ subsequent performance. Where the local authority is already cost competitive, the increase in overheads may offset the cost savings on sub-contracted operations.

Failure to appreciate the nature of the risks involved has contributed to the relatively poor earnings of some of the leading firms providing services to local government and the NHS. Exhibit 4 provides the details of trends in the share prices of two large suppliers of services to the NHS and local government. Even though the companies concerned have other interests as well, these unhappy examples may serve to deter potential suppliers from entering the field.

See also, A Chastening Experience by David Brindle of the Financial Times reproduced in the December 1986 edition of Local Government Manpower.
"... authorities would be unwise to assume all the benefits of enhanced competitiveness will be realised easily by handing over the problem to the private sector."

15. At the same time, the Commission believes that effective local accountability requires that the costs of in-house services are tested regularly against the local market place. If the in-house service is not competitive in price and performance with the private sector, the work should be contracted out. Local authorities should, therefore, seek a balance between in-house capability and contracting out of individual services, in light of the performance of the present in-house service against the available benchmarks of good performance and taking account of the factors summarised in Table 3.

### Table 3: CONTRACTING OUT LOCAL SERVICES

<table>
<thead>
<tr>
<th><strong>Advantages</strong></th>
<th><strong>Disadvantages</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Generally lower costs</td>
<td>Less direct control</td>
</tr>
<tr>
<td>Tighter financial control</td>
<td>Less flexibility in use of DLO staff</td>
</tr>
<tr>
<td>Reduced management ‘load’</td>
<td>Increased overheads</td>
</tr>
<tr>
<td>Clear service standards</td>
<td>– letting the contract</td>
</tr>
<tr>
<td>‘Competitive’ ethos</td>
<td>– maintaining performance</td>
</tr>
<tr>
<td></td>
<td>Risk of exploitation once</td>
</tr>
<tr>
<td></td>
<td>DLO is disbanded</td>
</tr>
</tbody>
</table>

16. In short, authorities would be unwise to assume that all the benefits of enhanced competitiveness will be realised easily by handing over the problem to the private sector. The final section of this paper, therefore, discusses how authorities should put work out to tender.
Putting contracts out to competitive tender

17. The Commission's auditors have had considerable experience over the past several years in monitoring the implementation of the DLO legislation; and, of course, some 35% of the work involved in auditing local authorities has been contracted out by the Commission to firms of private auditors. This experience suggests that four requirements need to be met, if the maximum benefits of increased competition are to be achieved:
   (i) Careful advance preparation, so that the standard of service to be provided is appropriately defined before the service is put out to competitive tender.
   (ii) Straightforward evaluation criteria.
   (iii) Retention of flexibility for the authority.
   (iv) Effective action to ensure that anticipated benefits from increased competition are achieved.

The balance of this paper expands on each of these points in turn.

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Careful advance preparation

18. Before work is tendered for in competition, it must first of all be described in detailed written specifications. Staff willing and able to carry out the necessary monitoring work have to be trained and assigned to it. The Commission's auditors and staff have gathered information about how different local authorities get their work specified, priced, competed for and supervised.

19. It cannot be assumed that because work has been contracted out, it can be put up for public competition; the first and most important point is that the "technology" for competition, in the form of methods of description and measurement, is not at present exist...at present exist ...

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Straightforward selection criteria

22. As stated above, the Commission does not believe that all privatised services are automatically going to be more cost effective than direct labour. Nor are all contractors equally cost competitive. This is perhaps most easily demonstrated by the following table of bids received for a typical recent local authority building contract:

<p>| Table 4: TWO RECENT BUILDING CONTRACTS |</p>
<table>
<thead>
<tr>
<th>Bid</th>
<th>7 Flats</th>
<th>12 Dwellings</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>£120.9</td>
<td>£245.5</td>
</tr>
<tr>
<td>2</td>
<td>124.4</td>
<td>265.0</td>
</tr>
<tr>
<td>3</td>
<td>129.6</td>
<td>295.8</td>
</tr>
<tr>
<td>4</td>
<td>140.3</td>
<td>317.6</td>
</tr>
<tr>
<td>5</td>
<td>145.5</td>
<td>319.9</td>
</tr>
<tr>
<td>6</td>
<td>149.1</td>
<td>342.0</td>
</tr>
<tr>
<td>7</td>
<td>151.9</td>
<td>344.9</td>
</tr>
<tr>
<td>8</td>
<td>151.9</td>
<td>345.8</td>
</tr>
</tbody>
</table>

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Preferably all the bidders had similar costs of capital. So long as the DLO has absorbed an appropriate share of the corporate overhead and is bearing the depreciation charges on the equipment and the financing charges on the fixed and working capital, the lowest bid for a given standard of service should be accepted - provided always that the organisations invited to bid are all considered competent to carry out the terms of the contract (no organisation should be invited to bid simply to make up the numbers).

24. Such an approach would mean that contracts would be awarded simply on the basis of the prices quoted. The contract period should not be specified in legislation. This will need to be determined locally and to reflect the likely start-up costs which will differ from service to service and place to place; the track record and financial reserves of the successful bidder and the perceived technical and managerial risk involved. In particular, a new contractor should, obviously, not be offered as long an initial contract as a more well-established supplier - even though there can be a
memorandum of understanding of an extended contract subject to satisfactory performance, with agreed price escalation clauses.

25. The lowest-price-bid approach ignores the whole question of the notional 'profit margin' of the DLO. The Commission does not believe it appropriate to specify that the DLO should be required to earn a target 5% CCA return on capital employed (ROCE). Quite apart from the issue of perceived equity - some, at least, of the companies bidding on the contracts shown in Table 4 above were evidently not expecting to earn similar real returns - balance sheets are always liable to manipulation to reduce recorded capital employed artificially. Data-stream analysis shows that the average CCA return (pre-tax profit plus interest charges) on capital employed for leading publicly quoted construction companies was 6.5% in the last year reported. Moreover, in labour-intensive organisations, capital investment is quite small, so ROCE is not a particularly relevant measure in any event.

26. The objective of competition is to secure lower prices and costs for equivalent standard of service - not simply to substitute private sector suppliers for public sector ones. Moreover, the private sector is not without significant competitive advantages in bidding for work. In addition to lower labour costs, because they are not party to the nationally negotiated terms and conditions of service, a private sector contractor can bid on a 'marginal' basis simply to contribute to his fixed overheads. This flexibility should be available to the DLO.

Retain future flexibility

27. The Commission takes the view that in most cases it is wise:
(a) To have several suppliers, rather than one for a key service, so that a private monopoly is not simply substituted for a public one
(b) To work with suppliers, so that the contract arrangements are designed to minimise their costs - which will in turn be reflected in lower prices for the authority
(c) To introduce any changes gradually, on a piece-meal basis rather than all at once. This will minimise the technical risks for the authority and the management and financial risks for potential suppliers. If all the service is contracted out at once, start-up costs for a typical contract in a London borough might amount to £1 million in plant, vehicles and working capital for parks maintenance and £500,000 for refuse collection
(d) To retain firm management control over the rate of change in running down (or building up) DLOs. This may sometimes mean that DLO tenders which are not the lowest have to be accepted - where for example LA believes that it would be premature to close down part of a DLO on the strength of a single market test.

Needless to say, the reasons for any such decision would have to be stated in the DLO annual report, and early opportunities would have to be sought to re-test the DLO in doing work of the type concerned.

28. This approach suggests that, generally, only part of each service should be put out to tender at any one time - although there would be no reason for an authority not to go beyond any defined minimum limit, if this seemed appropriate in the light of local circumstances. The economic costs of this gradualist approach do not seem likely to be massive: none of the Commission's studies has so far revealed any large economies of scale in respect of local authority functions; indeed, there is circumstantial evidence of managerial diseconomies of scale.

29. The question of how much work to put out to tender then arises. Ideally, this should be left for local decision. The Commission is aware of attempts to avoid the necessity for DLOs to compete, by packaging work in such a way that no local private supplier is likely to be able to compete for the contract. The report on council house maintenance provides some examples of the kind of practices which have this effect. Such strategies amount to deliberately destruction of local value - because the supposed interests of DLO employees are placed above those of the authority's customers or its ratepayers. Generally, standing orders should specify that services should be put out to tender in lots of not more than £50,000 (about the annual cost of cleaning and caretaking costs for a comprehensive school and the break-point for contracts in the current DLO legislation). Compliance with these requirements would be relatively easy to check and to understand; and the scope for manipulation by creative accounting would be small.

Securing performance

30. The pen is mightier than the sword. Auditors' experience is that, for almost all authorities, the prospect of public exposure of waste and inefficiency will be more effective in securing constructive action than the threat of legal proceedings. Effective local accountability, not the courts, is the best insurance against local waste and inefficiency; and the Commission and its auditors are determined to do their part to see this accountability strengthened.

31. However, there are four further measures which would complement the proposals set out above, and which the Commission believes would contribute to realising the full benefits from increased competition:
(i) All bids for services should be submitted in a common format showing the following cost information: direct labour, supervision, overhead allocation, materials, capital and financing charges, other costs/profits. This approach is common practice in industry where important sub-contracts are being let e.g. in the aerospace and automotive industries. It will allow the pure basing authority to assess the realism of the various bids that are received and the auditor and the courts to judge whether the authorities' decisions were reasonable. It will also provide the basis for some very useful cost comparisons between authorities.
(ii) All tenders should be advertised locally, and at least three pre-qualified bidders from separate organisations (not, for example, three subsidiaries of the same organisation) must be obtained. It is usually sensible to include an out-of-area competitor in the bidding list; the Commission and its auditors are uncomfortably aware of the possibility of local 'price rings' and of the list of those invited to tender being manipulated.
(iii) All bids should be published with each bid identified separately (but anonymously - as in the table above). There will often be sound reasons for not accepting the lowest bid; but any authority not accepting the lowest bid from a pre-qualified supplier should be required to state the reasons for its decision publicly.
(iv) Every year, the external auditor should review a sample of large jobs carried out by the DLO to verify that the work done and costs incurred are in line with the original successful bid. The Commission has noticed that some DLOs avoid the need to compete by quoting unrealistic prices in the first instance. Having secured the contract by bidding low, they seek to load their extra costs onto the customer by way of alleged variation orders, escalation clauses and so forth - a practice not unknown elsewhere in the building industry.

32. In addition to its other advantages, such an approach would strengthen local accountability. It would be clear who the 'maker or buy' decisions were being made: so government could not reasonably be blamed for any problems that might follow inadequate performance by contractors. The cost to local ratepayers of accepting other than the lowest bid would similarly be clear: and the authority would have the opportunity to justify any cost premium paid.

* * *

The Commission is aware of a wide range of strategies adopted by authorities to avoid tackling the problems of non-competitive infrastructure services. Quite apart from any legal considerations, such moves are misguided. There is a massive backlog of work outstanding on council house and school maintenance in particular. So non-competitive local authority services are, quite simply, destroying value to no good purpose. The proposals set out above are designed to realise the potential value improvements worth some £500 million a year which seem to be available.