

Competitive Neutrality: Ensuring a Level Playing Field in Managed Competitions

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EXECUTIVE SUMMARY

Increasingly when governments decide to test the market for providing services, in-house units are also given the opportunity to bid for providing the service. This model of public-private competition is often referred to as “managed competition.”

While managed competition has brought competition to many jurisdictions where public services had long been the exclusive domain of public monopolies, increasingly private providers are crying foul, arguing that the playing field is usually tilted against them in public-private competitions. Their complaints run the gamut: the public units fail to include all their costs in their bids; a performance guarantee is required from the private bidders, but not from the public providers; risk assumed by the private sector is not valued and; the private bidders must pay taxes and comply with regulations for which the public sector is exempt.

A competitively neutral competition policy requires that in-house units of government should not enjoy a net competitive advantage over their private-sector counterparts simply by virtue of public-sector ownership. At the same time, to the extent possible, institutional constraints that hamper the public-sector unit’s ability to increase productivity, and therefore effectively compete with the private sector, should be eliminated.

Currently, there are no real guidelines that lay out how governments should conduct fair public-private competitions. This study is an attempt to set out a series of policies to guide governments in setting up competitively neutral programs of managed competition.

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Part 1

Introduction

No reporting process, auditing procedure, or budget procedure has ever gotten a public organization to put anywhere near the energy into improvement that competition has. Enormous energy goes into getting prices down for bids.

—Phoenix City Auditor Jim Flanagan

From operating water systems to running welfare-to-work programs, traditional public services are being opened up to competition from the private sector. Competition has become the mantra of governments seeking to cut costs and increase service quality. The notion that governments can often provide the lowest-cost, best-quality public services by “purchasing” them from the private sector, rather than “delivering” them themselves, has gained widespread acceptability throughout the world.

Increasingly, when governments decide to test the market for the best price and quality for delivering a particular service, in-house units are also given the opportunity to bid. This model of public-private competition, referred to as “managed competition,” is predicated on the notion that allowing the widest possible range of competition between different types of providers is the best way of ensuring high-quality services at the lowest price with guaranteed performance.

Managed competition has brought competition to many jurisdictions where public employees had long enjoyed a protected monopoly on service delivery. At the same time, by giving public employees the opportunity to compete for contracts, managed competition has reduced political opposition to competitive contracting.

For private providers, the advent of the managed-competition era is a double-edged sword. On the one hand, it gets them in the door of many governments where previously they would have been shut out due to political and/or ideological opposition. “Initially it was a good idea because many cities that wouldn't have used competition because they didn't have the political will, did it,” says Steve Steckler, President of Infrastructure Management Inc, a consulting firm specializing in privatization.¹

The flip side is that managed competition introduces a new competitor into the game. This competitor, the municipal employee team, enters the arena with several decided advantages over private firms: they pay almost no taxes, they don't have to earn a profit, their cost of capital is cheaper, and they don't have to bear the costs associated with the financial, liability and compliance risks that are typically borne by the private operator.

¹ Steve Steckler, interview with the author, May 1997.

These advantages, together with the perception from many private providers that the playing field is usually tilted against them, has sparked considerable controversy over managed competition. Private firms frequently accuse the public employee teams of “low-balling,” “hiding costs” and generally “not playing fair.” Some private providers believe it is virtually impossible to create a level playing field in managed competitions.² “Leveling the playing field may sound fine in theory, but in practice it just never happens,” contends Paul Meyer, Executive Director of the Consulting Engineers and Land Surveyors of California (CELSOC). “In actual fact, we have never witnessed a single example of a truly level playing field involving public and private-sector competition.”³

Others believe that while it is possible to have fair public-private competitions, it isn't easy. “While you can't get to a 100 percent even playing field, you can get close,” says Michael Gagliardo, Executive Director of the Urban Water Institute of the U.S. Conference of Mayors, who points out that few governments have really thought out how to ensure a level playing field.⁴

Part of the problem is that uniform guidelines laying out how governments should conduct fair public-private competitions don't exist. The result is that the rules of the game vary from city to city, county to county and state to state (sometimes the rules even change in the course of individual procurements). The result is uncertainty, misunderstanding—and, ever more frequently—lawsuits from private bidders.⁵

Built-in Advantages and Disadvantages of Government Units vs. Private Providers



Public Advantages

- Enjoy lower cost of capital
- Pay little or no taxes
- Don't have to earn profit, rate-of-return on investments, or depreciate expenses
- Have first hand knowledge of operations
- Enjoy sovereign immunity/indemnification
- Can get self insurance
- Exempted from some laws and regulations
- Have close relationship with the staff evaluating bids
- Can cross-subsidize commercial operations from functions where they hold a monopoly on service

Public Disadvantages

- Face inflexible work rules
- Have to bid cost
- Subject to rigid procurement and personnel rules
- Experience higher employee benefit levels
- Lack direct access to capital markets
- Face constitutional and statutory constraints
- Have less economies of scale
- Cannot move quickly on capital spending

² Doug Herbst, Vice President of Professional Services Group (PSG), a leading wastewater and water operator, interview with the author, May 1997.

³ Paul Meyer, letter to the author, November 7, 1997.

⁴ Michael Gagliardo, interview with the author, June 1997.

⁵ In Australia, the Australian Bureau of Statistics is “wary of putting up in-house bids as they are regarded with some suspicion by the [information technology] IT industry—some vendors have indicated that they prefer not to enter into competition against in-house bids. See: “Industry Commission, *Competitive Tendering and Contracting by Public Sector Agencies*, Australian Government Publishing Service, Melbourne, Australia, Report No. 48, January 24, 1996, p. 298.

If not rectified, this mistrust could ultimately spell the death knell of managed competition as private providers refuse to participate in competitions that include the public sector. “To the extent that the private firms don’t bid, that will take the competition out of managed competition,” says Gagliardo.⁶

If managed competition is to become a major tool for driving change and increasing efficiency in the public sector then governments must do a better job creating a level playing field between public and private bidders. Drawing on best practices from around the world, this study is intended to provide a uniform managed competition template that addresses the major issues encountered when government departments compete against private firms to deliver public services.

⁶ Gagliardo, June 1997.

Part 2

Managed Competition: Background and Trends

A. History

Managed competition was first pioneered by the City of Phoenix's Public Works Department in the late 1970s. For 20 years, Phoenix has made competition between city units and private providers an important component of delivering city services ranging from waste collection to tree trimming.

Though Phoenix earned some international attention for its public-private competition program, the idea failed to really catch on elsewhere until the late 1980s when Great Britain passed the Local Government Act. The act required local councils to put six designated services out to competitive tender.⁷ Drawing on the British model, similar legislation was adopted in the early 1990s at the state level in Australia and in New Zealand.⁸

Meanwhile in the United States, the popularity of Reinventing Government—which extolled the virtues of the Phoenix model—together with the growing success of Indianapolis's competition program have raised the profile and popularity of managed competition.⁹ Since then dozens of other

Percentage of Competitive Contracting that Involve In-House Bids



<u>Government</u>	<u>Percentage</u>
Great Britain	
– Central	40%
– Local ¹⁰	80%
Australia	
– Commonwealth ¹	9%
– New South Wales	1%

⁷ Historically in Britain there has been a higher reliance on direct public-service provision at the local level than in almost any other Western industrialized nation. Thus the introduction of compulsory tendering was a major sea change. It gave private providers an opportunity to compete for contracts in cities where previously they had been locked out by Labour councils heavily beholden to public-employee unions.

⁸ Unlike Great Britain, the State of Victoria in Australia allows municipalities to determine which services they subject to competition. The only stipulation is that 50 percent of services must be subjected to competitive bidding.

⁹ Over 500 governments have journeyed to Indianapolis to study the city's competition program where over 70 services have been put out to bid since 1992 for an annual cost savings of over \$40 million. The program has been profiled in hundreds of articles and in several books on government reform. Moreover, Indianapolis Mayor Stephen Goldsmith, together with the local AFSCME public employee unit, received a prestigious award from the Kennedy School of Government for their competition program.

¹⁰ Since the passage of the 1988 Local Government Act and the subsequent widening of the act, over 10 percent of all local government activities are subject to mandatory public-private competition. Robert Carnaghan and Barry Bracewell-Milnes, *Testing the Market: Competitive Tendering for Government Services in Britain and Abroad*, Institute for Economic Affairs, Research Monograph No. 49, 1993, p. 64.

governments in America have instituted programs of managed competition including Charlotte; Ormond Beach, Florida; Irvine, California; San Diego; Allegheny County, Pennsylvania; and the states of Virginia, Michigan, and Arizona.

Managed Competition: In-House Winning Percentage



Great Britain (local gov't) ¹	75%
Australia (Commonwealth)	15%
New South Wales	54%
Charlotte, NC ²	71%
Indianapolis, IN ³	72%*
Phoenix, AZ	39%
U.S. Water/Wastewater (IMG Survey) ⁴	69%

Notes:

1. About 75 percent of all local government contracts subject to competitive bidding have been won by the in-house bidder since the Local Government Act took effect.¹²
2. The public sector has won 24 out of 34 services subjected to managed competition between 1995 and 1997.¹³ Another 27 services were outsourced outright, thereby bypassing the managed competition process.
3. For major services, the private sector actually won about 75 percent of the competitions, according to Indianapolis officials. The high victory rate of public providers represented in the chart is misleading because of two factors: 1) most of the contracts won by public units were street contracts of under \$100,000 and; 2) the public sector chose not to bid at all on many contracts where they failed to have a competitive advantage.
4. Infrastructure Management Inc., a consulting firm based in Bethesda, Maryland, surveyed 27 governments that had bid out water/wastewater operations. The public sector submitted bids in almost half of these competitions, winning 69 percent of the time.

¹¹ In the Department of Defense, public-sector bids were much more common, with in-house teams winning about one-third of all services bid out. Ibid, p. 286.

¹² Tony Cutler and Barbara Waine, "Competitive Tendering: The Case of the Vanishing Producers," in *Managing the Welfare State: The Politics of Public Sector Management*, (Oxford: Berg Publishing Inc., 1994), p. 87. Also see: Howard Davis and Kieron Walsh, *Competition and Service; The Impact of the Local Government Act*, (London:HMSO, 1993), p. 93. A number of factors account for the very high success rate of in-house departments in the UK. These include: the built in preference for in-house service delivery of many local authorities—particularly those controlled by the Labour Party; a playing field skewed towards the public sector in many localities; the public sector being the only bidder in many of the competitions; little familiarity by UK governments with service contracting; greater familiarity with the work by in-house teams; and a less-developed market of private-sector service providers in the UK than in America.

¹³ "Competition Companion Document," City of Charlotte, May 6, 1997, p. 4.

Part 3

The Concept of Competitive Neutrality

“If a less efficient Government business is able to rely on net competitive advantage to take business from a more efficient firm, society's resources are not being put to their best use.”

—Australia National Competition Policy Report of Independent Committee of Inquiry, 1993

A. Definition

Competitive neutrality means designing a set of policies and legal arrangements that ensure that all organizations and individuals—public, private and nonprofit—are treated in an equal manner in the bidding process between public and private bidders. To the extent possible, all protections and special privileges that public units usually enjoy over private firms should be removed, as should barriers to the public unit's flexibility.

The process should be transparent and defensible. Clear guidelines must be established prior to the bidding process and be applied equally to all parties. All costs must be included in the bid and the process should be reviewed by an independent authority.

Competitive Neutrality: Key Elements

- Taxes or Tax Equivalency
- Arms Length Relationship w/Purchaser
- Formal Contract or Memorandum of Understanding
- Fully Allocated Costing
- Financial Penalties for Nonperformance
- Formal Appeals Procedures



Australia

In Australia, the Victorian Local Government Code of Tendering requires all local governments to treat in-house and external bids on the same terms. The code requires that in-house bidders be institutionally separated from the government purchasers of services and that all direct and indirect costs of in-house units be incorporated into their bid proposal.



Competitive neutrality has become standard operating procedure in Australia and New Zealand. In both countries, considerable energy has gone into creating institutions and procedures that give both the private and public sector confidence that they will be treated objectively and uniformly when bidding for public services. In Great Britain, the record is more mixed, as some local governments maintain a strong bias against private providers. The United States trails all three countries in the area of competitive neutrality; few governments have taken the time to develop competitive neutrality processes and institutions.

B. Why Governments Should Move Towards Competitive Neutrality

There are both transaction costs and political costs to implementing competitive neutrality. Given these costs, many public officials ask why they should go to the trouble of trying to create a level playing field? There are several key reasons:

Why Competitive Neutrality?

- Maintain integrity of process
- Sustain competition
- Increase cost savings
- Improve resource allocation



#1: Increased efficiency of government services

By creating a competitive market for the supply of public services, governments can realize the best value for taxpayer's money. Achieving a vigorously competitive market requires that all bidders be confident that the playing field isn't skewed against them. As a report by the Australian government notes, "reforms intended to promote the contracting out of services traditionally supplied by an in-house monopoly provider may be thwarted or undermined if the in-house producer's advantages serve to limit the emergence of effective competition."¹⁴

#2: Improved allocation of societal resources

In the absence of competitively neutral pricing policies, a government unit could price its product below a more-efficient private-sector producer. This would result in a net loss to the community because resources wouldn't be allocated to their most efficient use.¹⁵ Instead, resources would be wasted because an entity requiring a greater amount of inputs to produce a desired output would be providing the service instead of the more-efficient private provider.

¹⁴ F. Hilmer, M. Rayner and G. Taperell (Hilmer Report), *National Competition Policy* (Report of the Independent Committee of Inquiry into competition policy in Australia), Australian Government Publishing Service, 1993, p. 297.

¹⁵ "Competitive Neutrality: A Statement of Victorian Government Policy," Department of Premier and Cabinet, State Government of Victoria, Melbourne, Australia, 1996, p. 6.

Achieving Bidding Process Neutrality

A. Introduction

Conducting a fair managed-competition process is more difficult than outsourcing a service to the private sector. It is more emotional, more political, more complex, and can even be more costly than a procurement that is limited to just private firms.

Creating a level playing field requires that government do many things that are not necessary if the service is contracted out only to private entities, including: determining the fully loaded costs of in-house service, building a firewall between the government as purchaser and the government as service provider; and making transparent any differences between the public and private sectors.

Currently governmental entities have a variety of built-in advantages simply by virtue of their government status. The goal should be to reduce the net effect of any advantages or disadvantages the public-sector bidder enjoys simply on the basis of its status as a public institution.¹⁶

Governments often do a poor job ensuring competitive neutrality. In Great Britain, researchers have identified a number of anti-competitive practices of local councils, including failing to fully cost out in-house services, requiring excessive performance bonds from private firms, rejecting lower bids from private firms, and permitting in-house teams to adjust their bids or proposals after seeing the private bids.¹⁷

When designing a managed-competition program, public officials should strive to ensure as much equality as possible for each component of the procurement process, ranging from determining current in-house costs to defining the consequences for performance failure. While it may not be possible to have absolute equality in each area, governments should strive to get as close as possible.

B. Pricing/Costs

1. *The Issue*

The most-frequent complaint from private providers regarding managed competition is that the in-house team failed to include all their true costs in their bid proposals, thereby causing an unfair cost comparison in the bidding process. There is often some validity in this complaint.

¹⁶ “National Competition Policy and Local Government: A Statement of Victorian Government Policy,” State Government of Victoria, Australia, June 1996, p. 25.

¹⁷ Lawrence Martin, “Public-Private Competition in the United Kingdom: Lessons for U.S. Local Government?” *State and Local Government Review*, Vol. 29., No.2, Spring 1997, p. 84.

Anticompetitive Practices



- Failing to fully cost out in-house service costs
- Not requiring sealed bids from public bids
- Requiring excessive performance bonds from private firms
- Rejecting lower bids from private firms

Costing out public services is both an art and a science. Numerous guidebooks and studies are devoted solely to guiding governments through the often treacherous process of cost analysis.¹⁸

Finding out the full costs means determining the full, in-house costs, including both direct and indirect costs, and comparing it to the total contracting costs, including monitoring costs. Besides wages and benefits of the employees directly involved in performing the service, in-house costs must include all equipment,

vehicles, gasoline, utilities, rent, building maintenance, insurance, and so on. Any reasons for including or excluding any relevant cost information must be fully documented.

While a full discussion of the costing issue is beyond the scope of this study, certain mistakes are routinely made in estimating total costs. These include:

Cross Subsidization. Some costs of the target department often are borne by other departments in the same agency and not reported as a department expense. When determining costs, be on the lookout for in-house units trying to subsidize the part of their operations that must compete with private firms from protected parts of the unit. In several cities, solid waste pick up has been broken up into quadrants, some subject to competition and some reserved for in-house operation. Private firms have argued that the low bids offered by city units are the result of cross-subsidization.

Recommendations:

#1. Bring in an objective third party to determine the department's full costs.

#2. Extend competition as completely as possible into the department. Eventually, all functions will be exposed to competition, and there will be no protected areas remaining, making cross-subsidization unsustainable.

Preventing Cross Subsidization: Charlotte Trash Collection Case Study



In a managed competition for trash collection in the City of Charlotte, the in-house unit came in with a bid of \$1.9 million, much lower than the closest private bid of \$3.2 million. The private-sector bidders claimed the city team put in a lowball bid. They charged the department would simply shift costs from the unit subjected to competition to quadrants that weren't subject to competition.

The city's Privatization and Competition Commission posed the following question to the department: "If you can deliver the service for such a low price per unit in that particular quadrant, then why can't you collect trash for the same price in other quadrants."¹⁹ The rationale was sound: if the city team was bidding their actual costs in the sector, there is no reason why they shouldn't be able to reduce their costs to the same level in other quadrants. Ultimately, however, the city council failed to press this issue.

¹⁸ See the following for more extended analyses of the costing issue: *How To Compare Costs Between In-House and Contracted Services*, Lawrence Martin, Reason Foundation, How-To Guide No. 4, March 1993; *Privatization: The Key to Better Government*, E.S. Savas, (Catham: Catham House Publishers, 1987); *Rightsizing Government: Lessons from America's Public-Sector Innovators*, William D. Eggers, Reason Foundation, How-To Guide No. 11, January 1994; *Total Costing for School Transportation Service: How the San Diego City Schools Missed the Bus*, Janet R. Beales, Reason Foundation, Policy Study No. 199, December 1995.

¹⁹ Interview with Jack Sommer, former member of Charlotte Privatization and Competition commission, May 1997.

Public/Private Competition in the City of Phoenix: 1979–1994		
Service	Contracts Won by Private	Contracts Won by Public
Ambulance service	0	1
Billing service	2	0
Data entry	0	1
Fuel distribution	0	1
Instrumentation maintenance	0	1
Landfill operation	1	0
Landscape maintenance	23	7
Public defender	1	0
Refuse collection	7	5
Senior housing management	0	1
Street repair	0	2
Street sweeping	0	2
Water meter repair	0	1
Total	34	22

Source: *Government Finance Review*, June 1995, pp. 7–12.

Failure to Allocate Overhead. Indirect costs, or overhead, such as insurance, utilities, facilities, and administration, are often shared by many departments within an agency. Overhead costs that are frequently overlooked or underallocated include:

- Back office/administration costs;
- Personnel and payroll costs;
- Capital costs (land, use of storage yards and centralized maintenance);
- Workers compensation costs (these should be a function of a safety performance factor of an equivalent entity); and
- Legal costs (the law department is often allocated by head count, which can be an inappropriate allocation).

Recommendation: A portion of the overhead costs should be allocated to the target department or service based on its use of overhead support.

Understanding the Cost of Capital, Capital Requirements, and Replacement Reserves. Assets such as buildings, computers, and heavy equipment lose value over their lifetime. Eventually they are dumped, sold, overhauled, or replaced. The cost of this loss in value is the asset’s depreciation cost.

Recommendations:

#1. Depreciation costs, or replacement reserves, must be figured into the total cost of a particular activity.

#2. Interest expense on borrowed funds and debt also must be included in any calculation of total costs.

Failure to Account for Higher Service Levels. When calculating costs, make sure you are comparing “apples to apples” within what you are asking the contractor to provide. It would not be fair to compare a higher level of service from a contractor with what you might be spending in-house for a lower quality of service.

Recommendation: Cost-out what the in-house provider would have to spend to deliver the defined performance level.

Failure to Include the Costs of Outside Expertise. Often, the in-house teams subject to competition will hire outside consultants to assist them in preparing their proposal and reengineering their operations. This is an additional cost to the government and it should be included in the in-house bid. Be on the lookout for the department using creative techniques to charge this cost to other budget areas. Example: labeling reengineering and bid preparation an “automation project” and charging it to the capital account.

Recommendation: Include the costs of hiring outside consultants in the in-house unit’s bid price.

Failure to Disclose all Costs. To avoid the contractor making a blind bid, the government should release as much information as possible about its current costs. While the private sector doesn’t need to know the department’s fully allocated costs of delivering the service before they submit a bid, they do need very reliable cost (including historical costs) and budget data.

Failure to Account For the Taxes Paid by Private Firms. There are several different ways that governments deal with the issue of taxes. The first, prevalent in Australia and New Zealand, is to corporatize or commercialize the public bidding entity and then subject it to the full range of taxes. Second, public bidders can be subjected to “tax equivalent payments,” or in-house bids can be adjusted to account for tax liabilities. Third, the government can estimate the additional taxes that the private firm would pay to the city, county, or state government if they win the contract and then subtract this amount from the bid price. The last option, and the most common, is to not take into account taxes at all in the bid prices. This is the least fair approach.

C. Sealed Bids and Proposals

The Issue

Some governments have tilted the playing field against the private sector by exempting in-house units from the requirement of submitting sealed, blind bids or proposals.²⁰ For example, several cities have made it a practice of allowing in-house units to put together their bids *after* being shown the best bids from the private sector. This allows in-house teams the opportunity to adjust their bid based on the private-sector proposals.

Even more troubling, in several competitions for emergency medical services (EMS), cities have taken the service in-house after fire departments have claimed they could provide the service cheaper. No cost documentation was asked for, or given.

In addition to corrupting the competition process, these approaches are likely to significantly reduce future cost savings from competition. Why? if private firms feel as though they’re only being used by politicians to obtain concessions from in-house units, they will soon decide it’s not worth the trouble and expense of putting together serious bids. The end result is less competition.

Recommendation: Subject in-house bidders to the same requirements concerning sealed bids and proposals as private bidders. All parties should be required to bid from the same RFP.

²⁰ In some states, local governments are prohibited by state statute from engaging in direct competition with private firms for services and activities that are primarily commercial in nature. In these cases, local governments will use more of a benchmarking approach to assess in-house versus private service delivery. While this is preferable to having no competition at all, it is all but impossible to create a truly level playing field using this approach.

Toledo, Ohio: Level Playing Field Controversies



When the City of Toledo released an RFP to operate its Bayview Wastewater Treatment Plant, the city union initially declined to submit a bid. Eventually they changed their mind, and the service was kept in house.

The Toledo bidding process was far from a model of competitive neutrality. First, the private firms only learned what the union bid was after the top private firm had been selected and had entered into negotiations with the city. Second, no firewall was constructed between the government purchasers and providers; several of the managers who evaluated and interviewed the private bidders also helped assemble the union bid.

Third, the rules of the game were never made clear and consistent throughout the process. The private firms knew they had to come in well under the union to be awarded the contract, but they didn't know by how much. Lastly, there is strong evidence that the in-house bidder failed to include its full costs—particularly electricity charges—in its bid proposal.

"[In Toledo] private industry was used as a club to beat up on the unions," says Andy Shea, Vice President of United Water Services.

D. Subsidies

The Issue

Governments may decide for public policy reasons to supply certain goods or services for free or below cost. Principles of competitive neutrality need not interfere with these objectives, but they will affect how such services are priced by in-house providers. Any subsidies provided by government should be made as transparent as possible and recognized explicitly in costing the services.

When New York City introduced competition into park and building maintenance several years ago, initially private providers won a significant number of the contracts. Subsequently, the city introduced its workfare program, and city units were given the use of what essentially amounted to free labor in the form of the workfare clients. Naturally, private providers couldn't compete against the free labor and competition for these services ceased. The city workforce received a subsidy unavailable to the private bidders.

In another case, a jurisdiction required that if a private bidder won the contract: 1) They had to hire all existing employees; and 2) No vacancies would be available in other departments to shift some of the displaced employees into. However, if the in-house unit won the bid, then such vacancies would be available.²¹

Recommendations:

#1. One objective of managed competition should be to decrease, or at least make transparent, subsidies to public-sector service providers.

#2. If the subsidy derives from other policy objectives, as in the New York City example, then when possible the subsidy should be available to both the in-house and external providers.

E. Qualifications

²¹ David Mannix, United Water Company, letter to the author, November 11, 1997.

The Issue

Private firms often complain that the public sector is automatically pre-qualified in managed competitions despite the fact that poor past performance may be a chief reason for going to managed competition in the first place. These critics also argue that on a strict apples-to-apples basis, the public sector can't typically measure up to the private sector in breadth of experience, number of contracts, and other factors. "How can the existing workforce compete with firms that operate facilities throughout the country and possess a network of national experts and resources?" asks Doug Herbst, Vice President of Professional Services Group (PSG).²²

Public employees counter that while they may not match up to the private firms in national or regional experience, they more than make up for this by their superior knowledge of local operations. Moreover, they reason that it's not fair to judge them by their performance when they operated in a noncompetitive environment. "It is not fair to indict public employees," says Doug Bean, the Director of the Charlotte-Mecklenburg Utility Department. "They haven't been given the time, resources, or incentives in the past to operate at peak efficiency."²³

Recommendations:

#1. Public units shouldn't be automatically pre-qualified in the competition process; however the sheltered, monopolistic environment they previously operated within should be taken into consideration in the short-listing process.

#2. The qualifications, including technical and managerial expertise of both public and private bidders, should be considered when awarding bids.

F. Allocation of Risk

The Issue

Depending on the service, private companies are typically asked to assume a host of risks when they contract with governments.²⁴ For environmental services, for example, the private sector must usually bear the risk for compliance with all existing environmental laws. If they fail to comply, they pay the fine. "If we were to mess something up, we would have to pay for it," says Jack Noble, Vice President of OMI, a provider of water and wastewater services.²⁵ Other risks may include: operational, regulatory, financial, and capital.

Recent experience demonstrates that the private sector is willing to bear a tremendous amount of risk in return for more control over how services are delivered. When the State of Victoria in Australia utilized the private sector to design, build, and operate three new prisons, the government was able to shift nearly all risk to the private sector. The three prison operators each were required to assume the risks for the design,

²² Douglas Herbst, interview with the author, June 1997.

²³ Doug Bean, interview with the author, July 1997.

²⁴ To be sure, there are strong differences of opinion regarding exactly how much risk the private sector bears in reality. "The city will have the lion's share of the risk in either case, because the private firms will not subject themselves to more than a deductible amount of risk," argues Frank Gill, the national program manager for municipal advocacy at HDR Engineering. "Private firms will accept risk only for what they can control." See Frank Gill, "A Reasonable Alternative," *American City & County*, February 1997, PS17.

²⁵ Jack Noble, interview with the author, May 1997.

construction, ownership, and management of the prisons, as well as for the finance risks associated with changes in interest rates and taxes, insurance, and government indemnities.²⁶

For health and human services, contracts are increasingly “capitated,” meaning contractors are paid the same one-time per client rate regardless of actual costs. Most financial risks per client are borne by the private providers. When Kansas privatized its entire child welfare system in 1996, the private nonprofits that won the contracts agreed to assume the financial risks if they failed to move children out of foster care in a timely fashion.²⁷

When a contract is awarded to the public sector, however, risk remains with the government—and ultimately with the taxpayer. For example, most private design and engineering companies carry professional liability insurance to cover “errors and omissions.” These costs are taken into consideration when putting together their bid. Public agencies typically don’t even carry this kind of insurance. This inability to shift or shed risk has economic costs that must be considered in evaluating the bids.

Recommendations:

#1. Examine the issue of risk before embarking on a managed competition project.

If shifting risk is very important for a particular function, consider not allowing an in-house bid. “The key issue that needs to be looked at with regard to many managed competitions is how important is shifting risk,” explains the Urban Water Institute’s Michael Gagliardo. “If it is very important, then the government should select only amongst private operators.”²⁸

#2. Risk allocated to the private sector in a transaction should be valued and added to the public bid.

In San Diego, city officials charged the public bidding team with the costs of insurance in a competition to operate the Otay wastewater plant.

G. Performance Guarantees/Bonds/Nonperformance

*It is not fair to require one level of certainty from one category of bidders and not from the other.*²⁹

1. The Issue

Legally binding performance guarantees are typically required of private firms when they enter into service contracts with the public sector. “The bottom line is that we’re prepared to warrantee our performance,” says United Water’s Andy Shea. “If we don’t perform, we’ll pay damages.”³⁰

²⁶ William D. Eggers, “Prison Reform,” *Infrastructure Finance*, December/January 1997, pp. 53-55.

²⁷ William D. Eggers, “There’s No Place Like Home,” *Policy Review*, May/June, 1997, pp. 43-47. To ensure quality services, the contracts also contained demanding outcome and performance standards, requiring the private contractors to greatly improve on the state’s previous performance. For example, the contractors are required to meet five adoption outcome measures. The most important, of course, is placement. Previously the state was placing only one-fourth of children in homes within six months of the child being freed for adoption. The contractors must increase the placement rate to 70 percent within 180 days and 90 percent within a year or it risks losing the contract.

²⁸ Michael Gagliardo, interview with the author, June 1997.

²⁹ “Competitive Tendering and Contracting by Public Sector Agencies,” Industry Commission, Australian Government Publishing Service, Melbourne, Report No.48, January 24, 1996, p. 295.

³⁰ Andy Shea, interview with the author, June 1997.

In the water/wastewater arena, for example, communities often require the private sector to guarantee the following: prices, drinking water quality, and insurance (workers comp, liability, and pollution control/abatement). Each of these guarantees carries with it a cost to the private firms, adding to the cost of doing business. Corporations must back up their promise to deliver the service at a certain price even if their costs exceed their bid price. In these cases, they may have to dip into bonuses, profits, or corporate assets to replace the money. In solid waste collection, in states like California, private contractors are required to guarantee to always achieve state-mandated waste diversion rates.

In addition, the private companies often are required to put up a performance bond to guarantee their performance over the multi-year contract.

When public employees win a competition, instead of signing a contract, they are typically required to sign a Memorandum of Understanding (MOU). Though the MOU tries to approximate a private contract, it is not legally binding on either of the parties.

Furthermore, public employee teams are usually not subject to the same performance requirements as are private companies. For example, they're rarely subject to financial penalties for cost overruns. If their costs exceed their bid price, it is the taxpayers that typically have to pick up the tab. "The consequences of performance failure don't exist in the employee bid," says IMG's Steve Steckler. "The structures always allow employees to get more but not less."³¹

With minimal downside risks to worry about, public units have more leeway than the private sector to submit a rock-bottom bid. "When I submit a bid, if my cost overruns are covered by others I can be more aggressive than if my overruns are covered by my organization," explains Malcolm Pirnie's Paul Eisenhardt, who has assisted with scores of water/wastewater privatizations.

Private providers argue that the bids put in by in-house units would be higher if they were subject to the same financial consequences as the private sector. "If a city said to the public employee bidders, 'Give us your credit cards and if your costs go over your bid we will charge your credit cards,' I can guarantee that their bids wouldn't be the same," argues PSG's Doug Herbst.³²

2. Public Sector Counterresponse

Public officials and sympathetic private consultants interviewed for this study took issue with several aspects of the private-sector position on performance guarantees.

First, they say that the public unit is actually under more pressure to perform than the private contractor because their contract can be pulled by the elected officials at any time.

Second, they argue that private-sector performance guarantees don't hold as much weight in practice as they do on paper. Change orders are common in contractual relationships, they argue, meaning that much of the work is done outside the actual contract. Moreover, contractual disputes will sometimes end up in the courts. "The value of the guarantee is difficult to substantiate before the fact," says Kenneth Rubin, Senior Economist at Apogee Research Associates. "The real question is what is the cost of perfecting the guarantee within the legal structure."³³

³¹ Steve Steckler, interview with the author, May 1997.

³² Douglas Herbst, May 1997.

³³ Kenneth Rubin, interview with the author, June 1997.

The last line of argument from the public sector is that if the ultimate goal is to get the best-quality services at the lowest-possible price for the taxpayers, then it makes little sense to add to the public bid the cost of a performance bond. “It [adding the cost of a performance bond] just artificially inflates public-sector costs by inserting costs that we don’t actually incur,” says David Cooke, Deputy County Manager of Wake County, North Carolina. “It simply increases the costs of the transaction.”³⁴

The purpose of performance bonds, says Cooke, is to protect government in the event the company walks away from the contract, goes bankrupt, or is simply unable for some reason to perform the service. The public units are not going anywhere, so there is no point in requiring a performance bond.

Indianapolis Solid Waste Collection: Holding Public Units Accountable



In a competition for solid waste collection, the city was broken up into quadrants, and both the city employees and private firms were awarded bids.

The Solid Waste Department had to sign a Memorandum of Understanding agreeing to be subject to the same set of performance obligations documented in the RFP. Indianapolis city staff now routinely investigate and notify the solid waste department's in-house haulers of quality breaches in the same manner as is done with private haulers.³⁵

But in order to make the impact of quality breaches on the in-house unit as similar as possible to the effect such breaches have on private-sector haulers, the city recognized that more needed to be done. In 1996, the city's contract-compliance division successfully sought to have an amount equal to the total amount of liquidated damages assessed against the department over the course of the last four months of 1995 subtracted from the pool of money originally earmarked for distribution to employees as incentive pay. Thus, the quality breaches caused each crew member's incentive bonus to be cut by about 10 percent.

Recommendations:

#1: Establish provisions for loss sharing (as well as gainsharing) for public units.

Like the private sector, public units should be subject to downside financial risk when they enter into an MOU. There are several ways to ensure that there are economic consequences when the public units exceed their bid price:

- Establish a “rainy day” or “cost overrun” fund the public unit is required to keep in hand in the event they exceed their budget. The cost of the fund would be added to their bid price. If the fund isn't needed, it can be used to provide a performance-based incentive for employees.³⁶
- Assess financial penalties to public units that go over their budget or miss performance quality targets. They could be allowed to “earn back” these assessed penalties by exceeding performance standards in a future time period or by exceeding performance standards in other areas during the same time period.³⁷
- Add the amount of overrun on the part of the in-house department to its next bid.
- Establish a threshold amount that if the in-house unit exceeds its bid price by it would not be allowed to bid in the next round.

#2: Apply severe sanctions if the public team fails to achieve the service levels agreed upon at the promised price.

³⁴ David Cooke, interview with the author, May 1997.

³⁵ Mike Brink, “Holding In-house Units Accountable in Public-Private Competitions,” *Privatization Watch*, Reason Foundation, July 1996, p. 6.

³⁶ This idea has been proposed by Paul Eisenhardt, a manager at the consulting firm of Malcolm Pirnie in San Francisco.

³⁷ David L. Hayes, “Advanced Issues in Outsourcing Agreements,” Fenwick and West law firm, 1994.

Such sanctions could include contract termination and ineligibility for the contract in the next bidding process. “If they [the public units] don’t perform, it is the responsibility of the government as purchaser to cancel the contract and not let the public sector bid the next time,” says J.W. French, the Public Works Director for Lee County, Florida who has overseen several managed competitions.³⁸

#3: When possible, avoid requiring a performance bond from private bidders.

Performance bonds add to the cost of private-sector bids and also shut out many smaller businesses from competing for contracts. Depending on a variety of factors—risks of nonperformance, transition costs, size of contract, market of suppliers, start-up costs—requiring a performance bond may be unnecessary. Another alternative is to ask for a project guarantor instead of a performance bond.

Tensions Come to a Boil in Charlotte³⁹



Tensions came to a head in the summer of 1996 in Charlotte, where some of the world’s leading water companies went head-to-head with the public sector in a fierce competition to operate two city wastewater treatment plants. The winning bidder was the Charlotte-Mecklenburg Utility Department’s (CMUD) reengineering team, CM-ConOp. By trimming its costs by nearly 36 percent, the CM-ConOp team beat out a half dozen top wastewater companies, coming in 19 percent under its closest private competitor.

The large discrepancy in the bid prices shocked the private providers. “The gap should have been a lot closer,” says PSG’s Herbst, who, like most of the private bidders, believes the competition was skewed heavily against the private sector.

The charges from the private providers ran the gamut: CM-ConOp failed to include all its costs in its bid; the city required a performance guarantee from the private bidders, but not from CM-ConOp; the city ignored the whole issue of risk allocation; and the competition was scarred by a conflict of interest on the part of a city councilmember. “Charlotte gave managed competition a black eye,” says one consultant.

Charlotte officials vehemently deny the charge that the competition was in any way unfair. “We went to extreme lengths to make sure the competition was above board,” says former city official David Cooke, who ran Charlotte’s managed competition program. “A consulting firm was hired to administer the process and a citizens advisory committee was involved in each step.”⁴⁰

The large gap between the CM-ConOp bid and the closest private bid is easily explainable, argues CM-ConOp Director Doug Bean. It results from the private firms having to pay taxes and earn a profit, while the city employees must do neither.

The CM-ConOp team also received help from the Omaha-based engineering firm HDR, which took the team on a cross-country tour of top publicly owned, privately operated water plants. Upon their return, CM-ConOp and HDR promptly incorporated the best public and private-sector efficiency techniques into their bid.

Sorting out whether Charlotte intentionally—or unintentionally—tilted the playing field against the private sector is tricky. On the one hand, Charlotte officials clearly have a point when they argue that much of the griping is simply a case of sour grapes. “The private side was in some ways caught by their own arrogance,” says one observer. “They didn’t do their homework in Charlotte.”

On the other hand, the private firms do have some legitimate grievances, especially as they pertain to how the city dealt with the issues of risk and performance guarantees. If the contract had gone to a private company instead of CM-ConOp, Charlotte could have off-loaded a substantial amount of financial, operational, and compliance risks which were not accounted for in their bid price.

³⁸ J.W. French, interview with the author, July 1997.

³⁹ Adapted from William D. Eggers, “Privatization Killer,” *Infrastructure Finance*, September 1997, p. 23.

⁴⁰ Cooke, interview with the author, May 1997.

H. Preparing Government Units for Competition and Removing Disadvantages of Govt. Bidders

The Issue

Preparing public units for competition requires examining current work processes, labor practices, and personnel deployment and determining how they can be streamlined to make the work unit more cost efficient and productive.

Government units should not be asked to operate in two worlds simultaneously, the market and the bureaucratic. Internal government constraints which make it more difficult for government units to compete against private firms—for example, cumbersome procurement and personnel policies— should be eased or removed.

In determining how they can cut their costs and increase their productivity, public sector teams need to ask a series of questions about their current operations:⁴¹

- What businesses are we in?
- What level of service is currently being provided? What is mandated by law?
- What level of service should we be providing?
- What are our full costs? (Costs should be built from the ground up).
- Can we achieve purchasing and personnel flexibility?

Going through this exercise helps to get on the table why the public unit is not competitive and typically yields productivity-increasing recommendations. For example, when Indianapolis put its fleet maintenance operations out to bid, the public employees asked for more flexibility in scheduling of days off and agreed to forego some automatic cost-of-living increases in exchange for taking a portion of their compensation in performance bonuses.

In Charlotte, after public-works employees identified which current city practices made them uncompetitive, they were given considerable flexibility in personnel and procurement practices. They also bid out laboratory services, vehicle maintenance, and grounds maintenance.⁴² The savings from competing these services were incorporated into the utility team's winning bid to run the wastewater plants.

Governments typically give in-house units anywhere from a few months to several years to reengineer their operations and cut their costs in anticipation of competition. In Melbourne, Australia, the government gave the internal refuse collection unit three years to improve its operations before going out to bid. In Great Britain, central government agencies are given one year to prepare for competition. In some cases, once the decision has been made to compete a service, the in-house team is keen to shorten the adjustment period so the time of uncertainty isn't unnecessarily drawn out.

Recommendations:

#1. Give maximum flexibility to in-house units to reengineer their operations.

⁴¹ A number of these questions were supplied by John Williams, Senior Vice President of HDR Engineering, an engineering firm that has assisted numerous public units to reengineer their operations.

⁴² City entities were the low bidders for two of the three services.

In New Zealand, the government has given agencies unprecedented flexibility and in return has required from them a much higher degree of accountability. Procurement and financial management have both been devolved down to individual agencies. Department directors (called Chief Executives) now have the power to hire, fire, pay, promote, reduce (or eliminate) job classifications, and negotiate collective-bargaining contracts.

Southeast Water Purification Plant, Houston, TX



The 80-million-gallon-per-day Southeast Water Purification Plant near Houston serves 700,000 people in 13 cities, utility districts, or water authorities, each with various percentages of production capacity ownership. The City of Houston is the plant's managing partner and owns 23 percent. In early 1996, the city offered a five-year operations and maintenance contract for the plant in a "managed competition." The qualified bidders hailed from as far away as France and England, but also included competitors from the United States, along with a "company" owned by Houston area ratepayers.

Officials had conservatively expected around 10 percent savings from using a competitive-contracting process, and were delighted that the winning bid came in with savings of 43 percent from current costs. A change in technology offered by one of the private firms allowed for the huge drop in costs. The only way that the public sector could have won the bid was if they had offered the same change in technology. "The private company offered to take the risk of failure in new technology. It would have been hollow for employees to take the same risk," explains IMG's Steckler.⁴³

The 13 cities that own the plant will save \$12.7 million over the five years of the contract.

In Charlotte, departments have been reorganized into "Key Businesses." Department heads, now called Key Business Executives, also have the authority to hire, fire, pay and promote.

#2. Don't set an arbitrary time period for reengineering in-house operations but as a general rule the period should be as short as possible and no more than two years.

#3. Reduce the potential number of layoffs by holding positions vacant in anticipation of competition.

In addition to holding positions vacant, Hillsborough County, Florida, implemented an extensive retraining program for existing employees.⁴⁴

⁴³ Steckler, June 1997.

⁴⁴ "Managed Competition: Developing and Responding to RFQs and RFPs," Association of Metropolitan Sewerage Agencies (AMSA), Washington, DC, 1997, p. 21.

Part 5

Other Issues Related to Competitive Neutrality

A. Bidding for External Contracts

The Issue

Once a government initiates a program of managed competition, should the in-house team be allowed to bid for external contracts?

This is one of the most-contentious issues in the debate on managed competition. With only rare exceptions, private providers answer this question in the negative. Their opposition is understandable. They worry that the public sector will use its considerable cost advantages—they don't pay taxes or insurance premiums; they don't have to earn a profit; and they are often not required to comply with regulations placed on private firms—to take business away from them.

Another problem with government agencies bidding for outside contracts is that by doing so they increase their risk exposure. Ultimately, it is the taxpayers that will be left to pay the tab if the in-house team incurs losses from its external activities. In one city in New South Wales, Australia, for example, an in-house road authority won a contract to construct a road deviation for a neighboring city. The in-house agency underestimated the construction costs, and the loss was borne by the taxpayers from the jurisdiction of the in-house road authority.⁴⁵

Managed Competition: Areas of Contention



- Costing the public bid
- Qualifications
- Performance guarantees
- Risk valuation
- Accountability
- Taxes and regulations
- Institutional Separation

For their part, public-sector officials argue that if they are going to be exposed to private-sector competition, it is only fair that they should have the opportunity to bid on services in other jurisdictions. This argument, however, does not hold up to scrutiny. Under such reasoning, there is nothing to prevent public units from expanding their businesses infinitely and, in the process, putting private firms out of business.

⁴⁵ Industry Commission, p. 302.

Public officials also claim that taxpayers benefit from external contracts because they increase economies of scale and soak up part of the costs of overhead.

Bidding on outside work is treated differently, depending on the jurisdiction. Overseas, in Victoria, Australia, where competitive contracting is mandatory, bidding on external contracts is encouraged. In other states it is discouraged.

In New Zealand, many in-house bidders have been corporatized (called Local Authority Trading Enterprises [LATES]), meaning they must pay taxes and are expected to earn a profit. The LATES are allowed to bid for external contracts but are not supposed to be bailed out by governments if they fail to be profitable. “Our council would let them go bankrupt,” says John Norton, Deputy City Manager of the Hutt City Council, “We would then sell them off for whatever we would get for them.”⁴⁶

Critics are skeptical that councils will actually allow the LATES to go bankrupt in practice. “If a contract goes bum up, I can't see Wellington City Council saying we're going to let them go bankrupt,” says Angela Griffin, the Chief Executive for the Wellington City Council.⁴⁷ Griffin doesn't allow in-house units to bid for work outside the city, reasoning that it is unacceptable to subject the taxpayer to such risks.

Iowa DOT Compromise on External Competition



After winning a managed competition for state work, the Iowa Department of Transportation's paint-stripping unit sought to secure outside work to fill capacity and achieve greater economies of scale. The department allowed the work unit to do this, but under the following conditions:

- They could not engage in commercial advertising or marketing;
- They had to perform the work with existing personnel and equipment;
- They could not bid on outside work. Other government agencies would have to approach the unit and negotiate an agreement.

Such an approach could prove to be a fair compromise between the interests of private contractors and those of public work units, while safeguarding taxpayer interest.

Recommendations:

#1: Prohibit or restrict in-house units from bidding for outside contracts in areas where a commercial market exists, and prohibit in-house units from entering new businesses in competition with private firms.

Some states already prohibit governmental units from competing for external contracts.

#2: If you choose to allow external bidding, don't provide the in-house units with funding for capital or additional personnel to beef up their operations for external contracts.

The City of Indianapolis does not outright prohibit in-house units from obtaining outside work, but the city will not invest any public capital into helping them ramp up their operations. Moreover, any additional personnel must be brought on solely to work on new business and be paid fully out of new contracts. “We found that control over the sources of capital is the easiest way to protect the taxpayer's interests and rein in

⁴⁶ John Norton, interview with the author, August 1996.

⁴⁷ Angela Griffin, interview with the author, August 1996.

overly aggressive business growth of the department,” says Tom Olsen, former director of the city's enterprise development unit.⁴⁸

#3: If the in-house units bid on external contracts in commercial markets, they should be transformed organizationally into commercial or corporate structures and be subject to the same taxes and regulations as private companies.

B. Using Consultants

The Issue

Many governments have found that competitive neutrality is enhanced by hiring experienced consultants to assist them in writing RFPs and running managed competitions. Many consultants have conducted dozens of competition procurements and bring greater objectivity and credibility to the managed-competition process. “Don't try and do it yourself,” says J.W. French of Lee County, “We as public officials are at a disadvantage matching wits with people who do this all the time.”⁴⁹

Another advantage is that the consultant can take some of the heat off politicians and public officials if the losing bidders protest the bid selection. “When the javelins start coming, the consultant can stand out in front of the spear,” says French.⁵⁰

Many governments have also hired consultants to assist their in-house units in cutting costs and preparing their bids. Such assistance has been instrumental in the public sector winning bids in Charlotte, Indianapolis, and other jurisdictions. Hiring the same firm to assist the in-house bidders and to manage the competition procurement, however, is perceived by the private bidders as a serious conflict of interest. If it is deemed necessary to hire a consultant for the in-house team, the consultant should be separate and distinct from the one managing the competition, and their fee should be incorporated into the in-house bid.⁵¹

Recommendation: Use separate consultants to manage the competition process and assist the in-house team in preparing its bid.

Lee County, Florida: Few New Faces, Just Fewer Faces



When Lee County put its wastewater treatment plant out to bid, it received proposals from four bidders, including the county staff. The winning bidder, ST Environmental Services, came in \$7 million lower than the county staff and the next private bidder. Though bid protests were filed by both the county teams and another private bidder, the choice of ST Environmental Services was approved by the Board of County Commissioners.

Even though the savings were enough to finance a new water plant expansion and to add an injection well for effluent flow without any rate increases, no employees had to be laid off; the contractor agreed to take on all displaced employees and reduce the number of workers (from 90 employees to 70) through attrition. “We didn't see many new faces, we just saw fewer faces,” says J.W. French, Lee County's Public Works Director.⁵²

⁴⁸ Tom Olsen, interview with the author, May 1997.

⁴⁹ J.W. French, July 1997.

⁵⁰ Ibid.

⁵¹ A contrasting view is held by John Williams of HDR Engineering who writes to the author that “public employees subjected to managed competition usually enter the process with little or no preparation or internal support infrastructure. Private companies have an unfair advantage in that they have extensive resources and experience in the pursuit of new business. They are able to spread the costs of this support over numerous elements of their business and thus, reduce the ultimate cost of preparing each bid.”

⁵² French, June 1997.

C. Loading Requirements onto Private Sector Bidders

The Issue

From the standpoint of competitive neutrality, one of the most troublesome requirements governments impose on private bidders is “prevailing wage” or “living wage” laws, which require firms contracting with the city to pay a certain minimum hourly salary determined by either the city council or by prevailing union wages.

In San Jose, California, such policies—in addition to a 10 percent price preference given to in-house units and a no-layoff requirement—induced the San Jose Chamber of Commerce to ask: “Why would any business choose to compete under these conditions?”⁵³

Requiring contractors to match public-sector wages or arbitrary “living wage” levels can reduce possible cost savings and prevent many small businesses from bidding on contracts.⁵⁴ The providers should be allowed maximum flexibility to perform the given function in the most cost-effective fashion possible.

Recommendation: Avoid saddling the contractor with government wage and benefit mandates.

D. Public/Private Bidding Consortia

The Issue

Private companies have begun to team up with existing public units to bid against other private providers in numerous recent managed competitions.⁵⁵ When Texas prepared to go out to bid for its entire welfare eligibility and benefits system, Electronic Data Systems (EDS) partnered with the Texas Human Services Department to bid on the contract, while Lockheed Martin IMS linked up with the Texas Workforce Commission.

Though Texas was forced to abandon its ambitious privatization project due to federal opposition, the Texas project nevertheless raised important questions about how to ensure a level playing field when one of the bidders is a joint public-private venture. These questions include:

- Who is responsible for performance?
- Will the joint-venture ultimately reduce competition because other private providers won't bother to bid against public/private teams?
- Do any state constitutional provisions prohibit such joint ventures?
- Who is liable from both a compliance and financial perspective?

Public-private joint ventures have evoked strong criticism from some privatization experts who argue that the competition will degenerate into who gets to joint venture with the team of public employees, instead of who submits the best proposal. “It becomes a beauty contest,” says IMG's Steve Steckler, “a competition to see who gets to take the public employees to the dance.”⁵⁶

⁵³ “Just who is getting the benefit of city's new competition policy?” *The Business Journal*, San Jose, April 7, 1997.

⁵⁴ For an alternative approach see: John O'Leary and William D. Eggers, “Privatization and Public Employees: Guidelines for Fair Treatment, How to Guide #9, September 1993, p. 7.

⁵⁵ In Indianapolis, a public-private joint venture won a contract to collect sewerage fees. In San Diego, the Fire Department hooked up with Rural/Metro, a private provider, to win a contract for EMS services, and in Dade County, Florida, Lockheed IMS partnered with a county department to win a welfare-to-work contract.

⁵⁶ Steckler, June 1997. All other quotes in this section of the study are from the June interview.

San Diego Emergency Medical Services: Public/Private Joint Venture

For years, the private sector had provided emergency and non-emergency medical response and transport services in the City of San Diego, while the Fire Department had provided first-responder services. Then in 1997 the city expanded the scope of the EMS contract and opened it up to competition. With the number of fires declining in the city and the department looking for a new business opportunity, the Fire Department decided it wanted to bid on the contract.

The problem was that the Fire Department lacked any expertise in contracting with private hospitals and managed-care organizations, an increasingly important segment of the ambulance market. The department decided to try something unprecedented for fire departments: to enter into a joint venture with Rural/Metro, a private fire and EMS provider.

What makes the partnership all the more remarkable is that Rural/Metro is the largest private provider of fire services in the United States. "Rural/Metro, for years, was considered to be the enemy of the public fire departments," explains Ron Satoff, the fire union chief who negotiated the partnership.⁵⁷

The SDFD/Rural/Metro team easily beat out the other private competitors. The Rural/Metro-Fire Department bid was for \$3.75 million over five years, a full \$7 million lower than American Medical Response (AMR), which was the only other bidder.⁵⁸ If the joint venture team fails to perform at this bid price, both partners share the losses 50/50. If the costs go beyond \$6.5 million, however, Rural/Metro must bear all the risk. Rural/Metro also agreed to put \$8 million in start-up capital into the mix. "I believe this kind of partnership benefits both Rural/Metro and San Diego's firefighters," says Satoff. "I hope that this will be a model for the country."⁵⁹

The structure set up by Rural/Metro and the Fire Department is unique. They formed a Limited Liability Corporation (LLC) that will subcontract with Rural/Metro and the Fire Department for EMS services. The LLC's books will be open to the city, which will do periodic audits of its finances.

Highlights



- Public/private joint venture
- SD Fire Department and Rural/Metro
- 5-year contract for \$3.75M
- 50/50 split of losses up to \$6.5M
- Fleet maintenance and purchasing responsibilities transferred to Rural/Metro

"If you ask private companies whether they should allow joint ventures they will say no," says Steckler. "But if you allow it, they will fall all over themselves to beat at the door of the unions." Steckler believes these kind of joint ventures should be prohibited because, by reducing the competitive threat to the current service operator, joint ventures will eventually result in lower cost savings to taxpayers.

On the other hand, some private providers are favorably disposed towards joint ventures because they open doors to markets where otherwise they would have been excluded.

Recommendations:

#1: Research the legality of public-private joint ventures.

They may be unconstitutional in your state.

#2: Before allowing for joint venture, consider all the possible ramifications and unintended consequences.

#3: Allow for both partners to share in the risks and rewards but make sure taxpayers are protected from any loss.

⁵⁷ Ron Satoff, interview with the author, August 1997.


⁵⁸ One way the joint venture was able to supply such a low bid was that Rural/Metro will do the fleet maintenance and will purchase supplies, thus bypassing government's burdensome purchasing system.

⁵⁹ Satoff, August 1997.

E. Providing a Price Preference to Public Bidders

The Issue

Many managed-competition programs include a provision that the service not be contracted out unless the private sector comes in with a bid either 5 or 10 percent lower than the public bid. The rationale is that going from in-house provision to a private contractor incurs certain transition and political costs and that a minimum savings is needed to justify incurring such costs.

Preferential Pricing Policies		
Government	Price Preference to Public Bidders	
Irvine, CA	5%	
San Jose, CA	10%	
San Diego, CA	10%*	
Iowa DOT	5%	
Indianapolis, IN	none	
Charlotte, NC	none	
State of Michigan	5-25%**	

*Guideline that is applied on a case-by-case basis.
 **Percentage depends on the dollar value of the contract.

The problem with such a policy is that numerous other considerations other than low bid typically come into play when governments decide to outsource a service. Service quality, technological capability, innovation, managerial expertise, specialization and previous experience are all factors that often are considered when awarding a bid. A policy of only awarding a bid to the private sector if it is significantly under the public bid precludes governments from taking into consideration all these important factors. This is a major impediment to managerial flexibility.

Moreover, considering the public sector’s already built-in advantage in costs from not paying taxes or having to earn a profit, adding another 10 percent preference to this advantage would seem unjustified.

Recommendation: Do not give a price preference to the public sector in the bidding process unless transaction costs are very high and cost savings are the only motive for going out to bid.

F. Long-Term Contracts

The Issue

For long-term infrastructure contracts of 15-30 years, managed competition is generally inappropriate, because governments are generally looking for private capital investment when they enter into long-term contracts. Public employees have no means to raise the necessary capital.

Governments will also enter into long-term contracts in order to secure predictable service rates over a period of time. The private sector can guarantee such rates, while the in-house teams cannot, particularly if they include the cost of equipment repair and replacement or upgrade of facilities. “Public employees cannot predict rates for ten to twenty years if they include the provision of capital and stand behind them with any kind of guarantee,” admits HDR’s Williams. “They have nothing backing them up.”⁶⁰

Recommendation: Managed competition should not be employed for long-term infrastructure contracts.

⁶⁰ John Williams, interview with the author, June 1997.

Weighing the Costs and Benefits of Allowing In-house Bids



Advantages of Managed Competition

- Retains access to potential suppliers who have experience in performing the service.⁶¹
- Provides a level of safety going out to bid where the government is unsure of the external market.
- Spurs more internal reform of other units of government, creating a ripple effect.
- Creates less morale problems for the public-sector workforce.

Costs of Managed Competition

- Creates costs for in-house unit that is preparing a bid, including the training and capital costs incurred in getting the in-house unit ready for competition.
- Decreases competition where private bidders perceive that in-house bidders will be given preference.
- Generates a need to distribute more information to counteract perceptions of uneven playing field.

G. Complaints Process

The Issue

Private firms that either believe they were not given a fair shake in the competitive-bidding process or who have more general concerns over whether a managed-competition program has incorporated competitive neutrality principles need an objective entity where they can register their complaints. In Great Britain, Australia, and New Zealand, governments have established a formal complaint mechanisms to receive and investigate allegations that the playing field was tilted against the private sector in individual public-private competitions.

Recommendation: A formal complaint process should be instituted for private companies who claim that the bidding process was tilted against them.

H. Mandating that the Public Sector be Allowed to Bid

The Issue

In Irvine, California and several other cities that have adopted managed-competition programs, public officials have made it a policy to grant public employees the “right” to bid on any and all contracts.

This is a mistake because, for some services, the government may want to outsource the service to the private sector for reasons other than merely price. For example, the government may want to gain access to more advanced technology or worldwide managerial talent. Alternately, public officials may decide that the service in question is so far outside the “core” functions of government that they no longer want to devote managerial talent to providing the service. “Sometimes you begin with the idea that you will let the public entity bid,” explains Wake County, North Carolina official David Cooke, “But as you learn more about the marketplace and the competitive advantages of the private sector, you decide to outsource instead of doing a managed competition.”⁶²

⁶¹ *Industry Commission*, p. 287.

⁶² David Cooke, letter to the author, November 12, 1997.

The Government of Victoria recommends that local governments consider restricting the ability of in-house units to bid when the costs of bid preparation is high and the chances of the in-house team winning the bid are low.⁶³

Recommendation: Give managers the flexibility to decide whether managed competition or strictly private-private competition is appropriate on a case-by-case basis.

⁶³ *Industry Commission*, p. 290.

Part 6

Creating Institutions for Competitive Neutrality

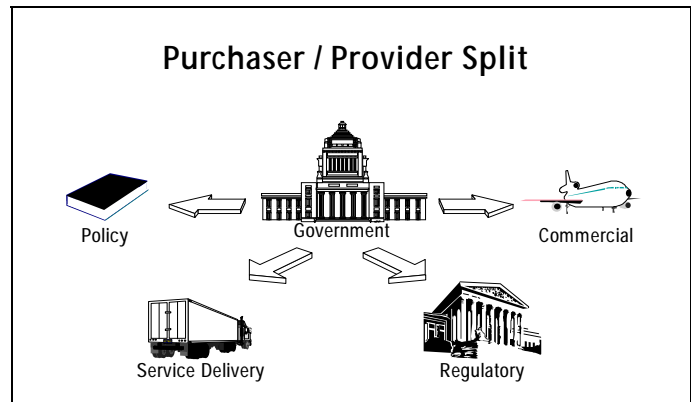
A. Building the Institutional Firewall: The Purchaser/Provider Split

For managed competition to be perceived as equitable by the private sector, a firewall must be created between the government as purchaser and government as service provider. From the private sector's standpoint, organizational separation is essential to maintaining confidence that the public sector is serious about having a level playing field.

The government unit responsible for bidding should be separated in both a physical and informational sense from that responsible for purchasing the service. The government bidding entity should be restructured to be a separate, yet connected, entity. Access to information and influence over the procurement process should be the same for both public and private bidders.

The best way to create a firewall between the government as purchaser and the in-house unit provider is to institutionally separate the purchaser and provider. This institutional reform is termed the “purchaser/provider split,” or “uncoupling.”

The purchaser/provider split allows policymakers to receive more objective policy advice. With the traditional organizational structure, there is a tendency of service departments to capture the policy advice process from policy makers, using this power to recommend themselves as service provider and to bias policy advice towards increasing the size of their budgets.



Splitting policy functions from service delivery creates incentives for governments to become more discriminating consumers by looking beyond government monopoly providers to a wide range of public and private providers.


The purchaser/provider split also better clarifies the roles of different units of government, increasing accountability, efficiency, and effectiveness. The government as purchaser sets clear performance standards and objectives and buys the best-quality service at the lowest-cost regardless of whether the provider is public or private. This allows government units that actually deliver services to concentrate on increasing their productivity and service quality.

Lastly, the separation is meant to reduce the conflicting objectives that arise when the same agency is involved in service delivery and regulation. In California, for example, numerous private firms have charged that the state transportation agency (Caltrans) has used its power to approve, disapprove, or stall plans and permit applications as a lever to win engineering and design work from local authorities. “Though it is never written down, project sponsors are promised fast track approval if the agency gets the work,” contends Paul Meyer, Executive Director of CELSOC.⁶⁴

B. Examples of the Purchaser/Provider Split

In Great Britain, an estimated 90 percent of all local authorities have taken some formal steps to separate the purchaser and provider.⁶⁵ Several organizational models are used to separate the government’s role as client or purchaser from that of provider.⁶⁶

**Purchaser/Provider Split:
U.S. Examples**



- Kansas ⇄ • Child Welfare
- Milwaukee County, WI ⇄ • Welfare, child welfare
- Sarasota County, FL ⇄ • Child welfare
- Indianapolis, IN ⇄ • Public works

In the state of Victoria in Australia, the government has separated policy and service-delivery functions throughout the state government. In the Corrections Department, the Correctional Services Agency is now exclusively a service-delivery agency. The Ministry of Justice is charged with “purchasing” correctional services and monitoring and evaluating the performance of private and public operators on a neutral basis.

The State of Kansas has undertaken a similar reform for child welfare services. Kansas’s Department of Social and Rehabilitation Services (SRS), previously the state’s largest provider of adoption and foster care services, now strictly purchases these services from a network of private providers.

Most public managers in organizations that have implemented the purchaser/provider split model would not want to go back to the previous organizational structure. “We introduced the commissioner/provider split in 1990,” says Chris Olsen, a manager for Cityworks in Wellington, New Zealand... To my knowledge, all the staff that have been involved in the split wouldn’t go back to the old ways.”⁶⁷

Recommendation: The government as purchaser should be organizationally split from the government as provider.

⁶⁴ Paul Meyer, letter to the author, November 7, 1997.

⁶⁵ Keith Shaw, John Fenwick and Ann Foreman, “Compulsory Competitive Tendering for local government services: The experiences of local authorities in the north of England 1988–92,” *Public Administration*, Summer 1994, pp. 207–208.

⁶⁶ Most frequent is what is called the lead department model in which contract monitoring and administration is distributed throughout the local authority. Most counties, on the other hand, have adopted an interdepartmental committee model in which contract administration functions are consolidated by creating a standing committee of in-house departments. See Lawrence Martin, “Public-Private Competition in the United Kingdom: Lessons for U.S. Local Government?” *State and Local Government Review*, Vol. 29, No.2 (Spring 1997), p. 80.

⁶⁷ “Making Wellington the City of Excellence: Improving the way we work,” Wellington City Council, September 1994.

When an in-house unit bids on a service, it should be prepared by an organizational unit that is separate from all aspects of regulation, bid evaluation, and service specification.

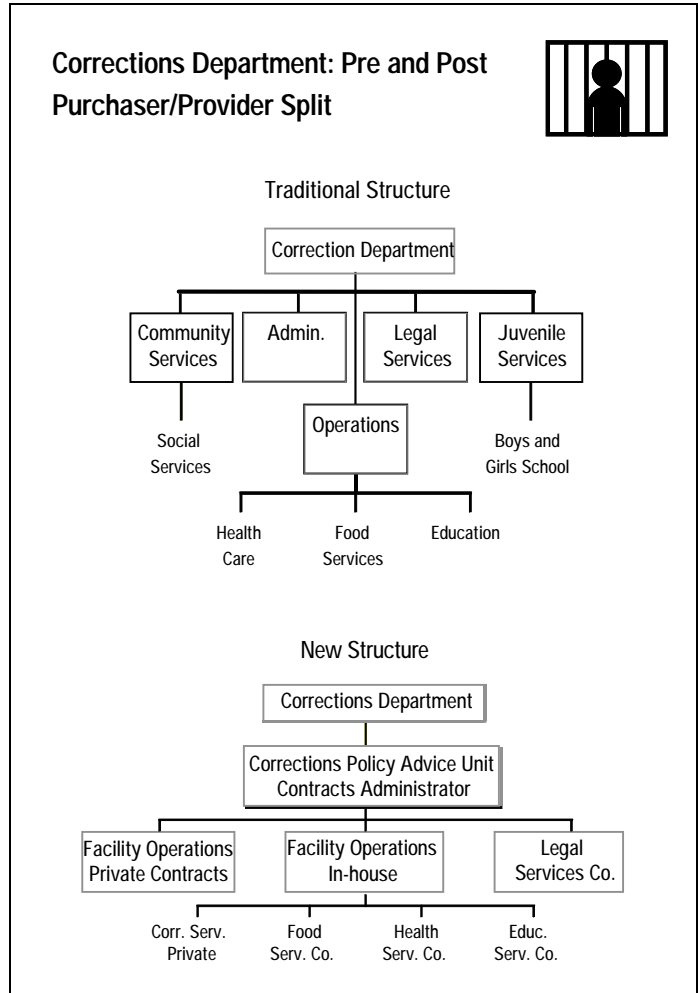
C. Corporatization

The purpose of corporatization is to convert the public enterprise into an organizational form that is as similar as possible to a private firm, while retaining government ownership. In this organizational model, the in-house team becomes its own distinct entity, legally separated from the parent agency. This structure removes nearly all the advantages and disadvantages that typically accrue to the public units by virtue of public ownership.⁶⁸

In New Zealand, many local governments have transformed public units into Local Authority Trading Enterprises (LATE). Though the local government is the chief shareholder in the LATE (the private sector can own up to 48 percent of a LATE), they are totally separated from the city's organizational structure. The LATEs have to borrow money on the market (the local government cannot loan a LATE money) and each LATE has a board of directors composed largely of private business people who require the LATEs to earn a commercial return for their shareholders. Local governments aren't supposed to bail out the LATEs if they lose service contracts and business goes sour.

LATEs are sometimes sold off. A LATE owned by the Rangitiki District Council in New Zealand was sold to Fulton Harbor, an engineering firm, after it had lost several road-repair contracts. LATEs and other corporatized entities could also be sold to employees in the form of an employee buyout. In this privatization model, the employees would become the owners of the entity, which would then contract back with government for delivery of the service.

Corporatization has many advantages from the government's perspective as both owner and purchaser. From the purchaser perspective, corporatization ensures the greatest degree of transparency between the in-house provider and the contracting agency.



The City of Melbourne has created a city-owned company called Citywide Services Ltd. The company consists of all the in-house teams which have won contracts over private firms in competitive bids. Citywide services is completely separate from the rest of the city organization.

⁶⁸ Industry Commission, p. 296.

From an ownership perspective, corporatization imposes some degree of commercial autonomy on the in-house provider—the need to cover costs, borrow money in the commercial markets, and return an appropriate profit. But corporatization also imposes additional costs on the government, including administrative and legal expenses; the costs of creating a separate entity; and some loss of political control.

D. Commercialization

Another option is commercialization, a less strict form of separation than corporatization. In-house teams are transformed organizationally into separate, autonomous business units that are required to conduct their operations on a commercial basis to the greatest degree possible. After commercialization, the unit typically has the freedom to purchase supplies and services from outside vendors and price their services on a more commercial basis. They also have to produce separate commercial accounts.⁶⁹

Commercialized government entities are typically required to pay taxes or, more likely, a tax equivalent, do full-cost, accrual-based accounting on the costs of their services, and carry a capital charge on their books.

Commercialization is fairly common in Australia and New Zealand. In the City of Bankstown in New South Wales, Australia, eight public units have undergone commercialization.

⁶⁹ *Industry Commission*, p. 297.

Part 7

Conclusion

In a relatively short time period, public-private competition has become a major public-policy trend throughout the Western industrialized world. For managed competition to continue as an effective tool to cut costs and increase efficiencies, an ample supply of private firms must be eager to bid against the public sector for the opportunity to deliver public services. This requires the private providers to be confident that the playing field will be level when they bid against public units and vice versa.

By following the set of common sense guidelines laid out in this guidebook, governments at all levels can maximize the benefits of competition and minimize charges of unfair favoritism or discrimination from private and public bidders alike.

Part 8

About the Author

Anationally recognized expert on privatization, William Eggers is the director of privatization and government reform at the Reason Public Policy Institute, the country's leading research center on privatization and state and local fiscal management issues.

Mr. Eggers is also the co-author of *Revolution at the Roots: Making Our Government Smaller, Better, and Closer to Home* (The Free Press). The book was named as the winner of the 1996 Sir Anthony Fisher International Memorial Award for the book "making the greatest contribution to the understanding of the free economy during the past two years."

A 1996 winner of the prestigious Roe Award for leadership and innovation in public policy research, Mr. Eggers has authored over a dozen policy studies on issues ranging from rightsizing government to tax reform.

Mr. Eggers graduated magna cum laude from the University of California at San Diego.

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Part 9

Additional Resources

Australia

“Competitive Neutrality: A Statement of Victorian Government Policy,” State Government of Victoria, Australia, 1996.

“National Competition Policy and Local Government: A Statement of Victorian Government Policy,” State Government of Victoria, Australia, 1996.

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“City of Irvine Managed Competition Manual,” City of Irvine, CA, March 11, 1997. Contact: Clay Martin, Senior Management Analyst (714) 724-6181.

“Managed Competition: Developing and Responding to RFQs and RFPs,” Association of Metropolitan Sewerage Agencies (AMSA), Washington, DC, 1997.

“Managed Competition Pilot Projects,” Iowa Department of Transportation, Ames, Iowa, May-December, 1996. Contact: Jim Chrysinger (515) 281-6537 or (515) 239-1197.