

# Serving the Community

*By Using the Private Sector*

June 2001

# Serving the Community...

## *By Using the Private Sector*

### The Government's goal

Meeting community needs in the most efficient and effective manner, including a target of optimising private sector involvement in the provision of services to the community.

### The purpose of this booklet

Confirming the Government's commitment to this target, and providing guidance to bureaux and departments to further their engagement with the private sector.

### The Government's policy

Consideration should always be given to involving the private sector in the provision of new services. And opportunities to improve private sector involvement in existing activities should be examined proactively. Decision-makers should begin with the presumption that the private sector can provide services to the community, while recognising that there will remain some special circumstances public sector provision may be necessary.

## Contents

### Page No.

#### Introduction

The private sector and Hong Kong's public sector reforms	1
Enhancing private sector involvement - Current initiatives	3
Maximising private sector involvement - Best practice	4
Options for involving the private sector	10



# Introduction

Enhancing public sector productivity is our pledge to the community. To achieve this we have a responsibility to make the best use of both the public and private sectors to ensure that government activities do not absorb more of the gross domestic product than is optimal for economic success.

The purpose of this booklet is to encourage increased outsourcing and other modes of involving the private sector in delivering public services. With its flexibility and vigour, the private sector can inject new thinking and initiatives to enhance the quality and efficiency of public services. We can then focus our limited public resources on identified priorities.

We should look to involve the private sector in new services. We need to be proactive also in examining existing activities to determine whether they can be provided by the private sector, or improved by managing better our current outsourcing contracts.

We need to have arrangements that:

- fully utilise the skills and resources available in the private sector;
- integrate the provision of services across departmental boundaries;
- bundle services to provide economies of scale and reduce life cycle costs; and
- share risks with the private sector reflecting the share of benefits.

This booklet expands on these issues and offers further guidance and examples of good practice. I encourage you to seize on the opportunities that private sector involvement presents and to pursue vigorously ways that creatively provide top quality services to the public.

**Donald Tsang**

Chief Secretary for Administration

## The private sector and Hong Kong's public sector reforms

In the last decade, the initial impetus for reforms in the public sector in Hong Kong came from initiatives to improve customer service to meet the community's needs. This was supported by establishing policy objectives for each bureau and by setting targets to manage organisational performance.

Private sector involvement was woven into these reforms, and into later initiatives which addressed new technology and the enhancement of productivity.

We are now giving new attention to the ability of the private sector to assist the government in meeting its priorities, building on the clear recognition that public funds are limited.

There is strong evidence of benefits to the community when the public and private sectors complement each other in the provision of public services. The government has a responsibility to make the best use of both sectors to ensure publicly funded activities do not absorb more of the gross domestic product than is optimal for economic success.

The public sector contributes positively to public/private partnerships. It brings:

- experienced and dedicated staff;
- significant public policy knowledge and skills;
- a unique source of data and intellectual property based on sound research; and
- a range of brands trusted in Hong Kong and beyond, some of which have commercial potential.

In turn, the private sector brings the disciplines of the market place to drive efficiency. And it has:

- experience in imaginative and creative provision of services;
- a culture of identifying and managing risks; and
- strong awareness of expanding markets, particularly capital markets<sup>1</sup>.

***Involving the private sector has long been part of Hong Kong's public sector reforms***

***The public and private sectors complement each other in providing services to the public***

***The public sector brings valuable resources and experience to the provision of services***

***The realities of the market exert powerful incentives and disciplines on private sector management***

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<sup>1</sup> Private funding of public services has expanded the market for fixed interest securities in other countries. The growth of funded pensions in East Asia suggests a need for an expansion in investment.



Efficient and effective service to the community occurs when the strengths of the two sectors come together. The taxpayer's money is then focused on achieving the highest priorities for the wealth, health and safety of the community.

The Hong Kong SAR Government has a long history of involving the private sector in delivering services, particularly through outsourcing. A survey in October 2000, covering 86 bureaux/departments, showed nearly four and a half thousand outsourcing contracts with the private sector, totalling more than HK\$31 Bn annual expenditure. But HK\$21.9 Bn was for capital works and construction suggesting that insufficient use is being made of private sector involvement in recurrent activities. And 84% of all contracts were for annual expenditure averaging of only HK\$1.5 Mn, indicating that most engagements were simple in depth and scope and that Hong Kong is missing out on value for money that comes with scale.

***There are limitations in the scope and size of current contracts with the private sector***

*Annual expenditure on current contracts in 86 bureaux / departments*

Category	No. of contracts	% Total contracts	Total annual expenditure HK\$ Bn	Average annual expenditure HK\$ Mn
Waste Management	19	<1	1.5	75.9
Capital Works & Construction	529	12	21.9	41.4
Infrastructure Maintenance	81	2	1.9	23.9
Transport Services	65	2	0.8	12.8
All Other Categories	3,676	84	5.5	1.5
Total	4,370	100	31.6	7.2

Better use of the private sector will allow both the government to focus its limited resources on identified priorities, and the economy to take greater advantage of the new opportunities that are arising in regional and global markets. As a result, the government has confirmed that the private sector should be considered first, unless there is compelling evidence to suggest otherwise.

***The private sector should be considered first***

To meet this policy, all bureaux and departments should take direct responsibility for regularly examining service activities to determine whether and in what manner they could be provided by the private sector. Bureaux and departments should then pursue new arrangements where there is evidence to suggest that benefits will accrue. At the same time, they should seek improvements in the arrangements for and management of current private sector contracts.

***Opportunities for new arrangements should be pursued by all***

## Enhancing private sector involvement – Current initiatives

Three approaches are being taken to expand and improve the involvement of the private sector:

**First**, a service-wide approach to improving existing and new outsourcing arrangements is being taken. As contracts come up for renewal or new opportunities are identified, departments are encouraged to consult the Management Services Agency’s outsourcing help desk. The staff there will provide expert advice on how to maximise the potential benefits from outsourcing arrangements.

**Second**, a selective approach is being taken to identify and implement opportunities for alternative approaches to private sector involvement, such as public/private partnerships. The Efficiency Unit, working closely with the Financial Secretary’s Business Advisory Group, specifically the Subgroup to oversee transfer of public services<sup>2</sup>, will continue to identify services with potential for making better use of the skills and resources of the private sector.

**Third**, during management reviews, which the Efficiency Unit and bureaux conduct from time to time, the opportunity will be taken to reconsider where the boundaries should best lie between public and private sector provision.

### Additional support

Further support for these measures will be provided by:

- ➔ A register of new and existing uses of the private sector.
- ➔ Documentation of good practice, based on departments with significant experience of outsourcing.
- ➔ Guidelines on tendering and contracting processes, addressing common issues.
- ➔ Procedures for the commercial exploitation of public assets through public/private partnerships.
- ➔ Developing approaches to managing employee concerns.

To avoid projects being seriously delayed or abandoned, because case-by-case issues prove too difficult, these comprehensive approaches will be developed in consultation with the Finance Bureau and the Civil Service Bureau.

***A help desk provides advice to improve existing and new outsourcing contracts***

***A selective approach is being taken to explore the potential for alternative approaches, such as public/private partnerships***

***Management reviews will consider the boundaries between the public and private sectors***

***New and existing uses of the private sector will be documented. Good practice, guidelines and procedures will be promulgated***

***Employee concerns will also be addressed***

<sup>2</sup> Currently chaired by Michael Tien

## Maximising private sector involvement – Best practice

The public's interest is not served by a slow or bloated bureaucracy, or by the inflated costs that come from a monopoly provider. Individual citizens can benefit directly from costs reduced through private sector provision. They also benefit indirectly from enhanced private enterprise - the engine of economic and social growth.

However, simply transferring as many public sector activities as quickly as possible to the private sector is unlikely to be the best solution. Experience shows problems can arise when trying to engage the private sector, if insufficient attention is paid to competition, regulation, or service standards. So care must be taken to ensure that best practice is adopted.

Maximising the potential of the private sector to serve the community requires close attention to:

- Removing barriers.
- Choosing the best approach.
- Considering institutional arrangements.
- Preparing well informed business cases.
- Encouraging creative tenders.
- Cooperation between departments.
- Contracting for value not price.
- Monitoring for results.
- Evaluating for the longer term.
- Taking advice and guidance.

This section outlines best practice in these areas. More detailed information on the different approaches to involving the private sector is provided in the last section of the booklet.

### Removing barriers

The task of the public sector is often more complex than that of the private sector because it faces multiple and often conflicting policy objectives. But this should not prevent a fresh examination of the potential for the community to be better served by using the private sector to deliver services. A key barrier has been the assumption that certain services are innately public.

***The public's interest requires that best practice be adopted***

***Government's responsibility is to ensure services are provided by whoever can do so most efficiently and effectively***

For example, it was once commonly assumed that all policing was an exclusively government function. Now it is generally agreed that security firms can legitimately protect private property and elements of traffic management are commonly outsourced. Some countries are now extending private provision to correctional services including prisons.

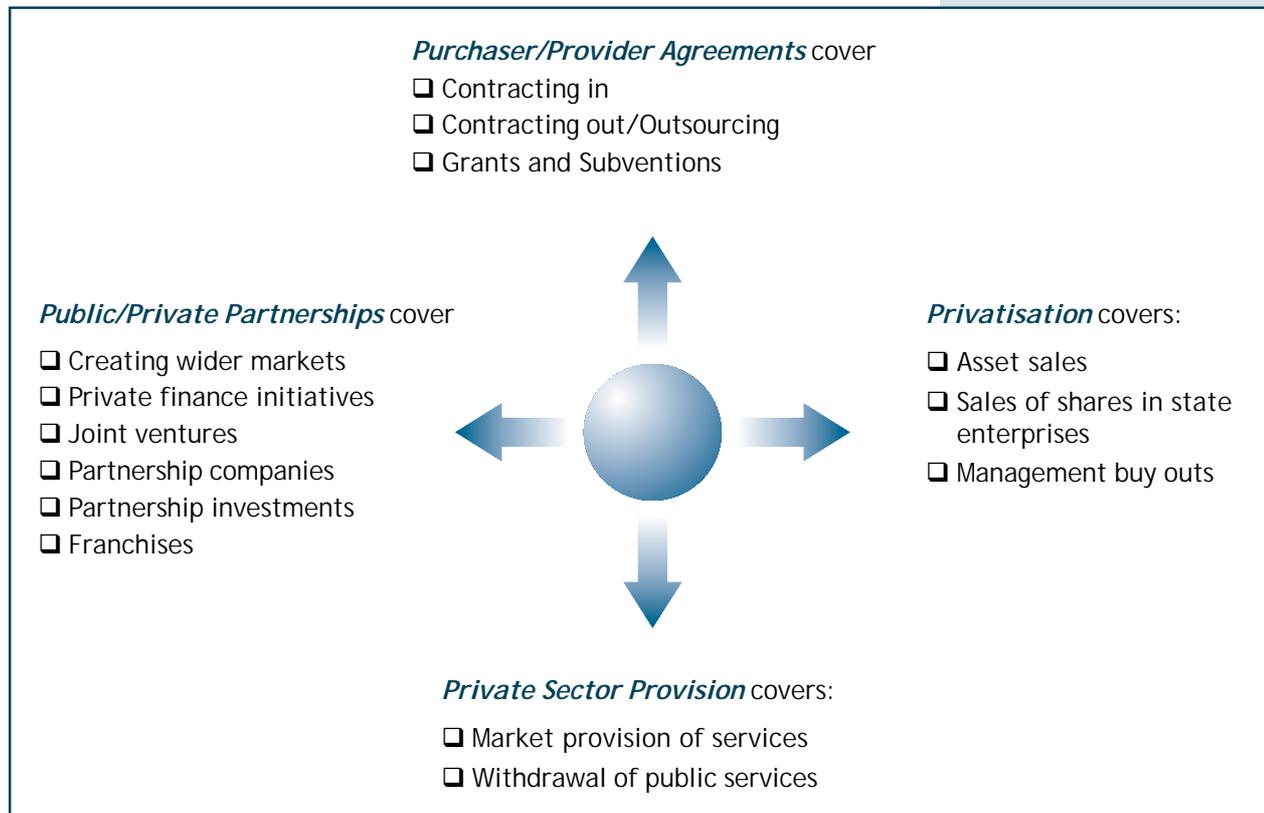
Other common barriers include: a reluctance to disturb the current arrangements; perceived and real regulatory constraints; a lack of imagination; or the application of excessive caution that is sometimes created by inexperience.

## Choosing the best approach

The Hong Kong SAR Government has undertaken many forms of private sector involvement but has mostly concentrated on the more direct forms of outsourcing<sup>3</sup>.

However, there are many available approaches that can be considered. The diagram below sets out various options for involving the private sector.

*Types of private sector involvement (for details see page 10)*



***Very few services are innately public***

***Outsourcing is only one way to engage the private sector...***

<sup>3</sup> Some activities such as construction of public buildings have always been outsourced, because the government has not possessed an in-house construction capability.

## Considering institutional arrangements

Where public sector organisations are pursuing initiatives that include an increase in the commercial nature of their activities, these may involve entering into a range of contractual relationships with the private sector. In some circumstances, corporatisation of a public service may be necessary to achieve the twin aims of providing an effective public service and increasing the return from public assets that have a commercial value.

In other circumstances, involving the private sector may lead to a public sector organisation abandoning its delivery role for a particular service and becoming solely a purchaser or regulator of the service in question. This may have an impact on the appropriateness of the institution's structure. This booklet does not deal with institutional effects. Guidance on such matters can be sought from the Efficiency Unit.

## Preparing a business case

To identify solutions involving the private sector that are truly competitive with the public sector, it is necessary to develop a fully costed business case comparing public and private sector alternatives.

Often, the costs of producing and maintaining facilities or services through the whole of their life are not fully considered by the public sector. Current practice usually gives separate consideration to capital and running costs, and there is rarely any assessment of alternative solutions for capital projects on the basis of any trade-off between the two.

A well developed business case should identify a cost effective combination or bundle of services to outsource. Contracts that cover services from 'beginning-to-end' can reduce transaction costs and encourage different approaches from the private sector.

For example, combined construction and maintenance costs can be lowered if the constructors also have the contract for maintenance, giving them an incentive to put more care into the selection of materials and equipment, and into construction.

Furthermore, many projects and programmes are currently divided into 'piecemeal' contracts for separate aspects of the projects. Contracts that achieve benefits for the community will be more readily achieved if large enough to engage the private sector creatively and cost effectively.

For example, building contractors are more likely to invest in innovative designs for schools, roads, hospitals or prisons, and use the advantages of scale in the procurement of materials and prefabrication, when they can apply these to multiple situations.

***Corporatisation may be necessary if service and efficiency aims are to be met***

***Or a split between purchaser/regulator and provider may be required***

***Through-life costing can lead to longer term savings***

***Bundling services can create savings for contractors and citizens***

***Piecemeal contracts increase transaction costs and limit innovation***

### Encouraging creative tenders

The department must be the judge of whether a tenderer meets the needs and standards required. To gain from private sector innovation, however, it must concentrate on what it is that a service is trying to achieve. Specifying outcomes, rather than inputs, means that potential contractors can propose different ways of meeting the goals.

A clear focus on the desired outcomes will also allow fair consideration of both conforming and non-conforming bids. Creative tenders, offering new solutions, may then allow new contractors to offer competition to existing contractors. This ultimately benefits the purchaser.

In calling for tenders, the department should balance its desire for the detail, which is needed to ensure performance, with allowing sufficient scope for differentiation by intending suppliers - giving them room to innovate in the substance of their bids, not just with prices.

Because the last 10-20% of a specification can cost as much as 50% of the total price, less detailed specification of tenders can often offer greatly reduced prices. Alternatively, an enhanced specification may emerge which can be delivered at little or no extra cost.

### Co-operation between departments

Co-operation between departments can significantly improve the value of initiatives involving the private sector. Adopting best practice will assist, but co-operation should also extend to departments with common functions.

A good example is the combination of the Drainage Services Department, the Water Supplies Department and the Highways Department to allow private sector contractors to carry out some or all of drainage/sewerage connections, water supply, and construction of run-ins and footpath repair.

Recognising the government as a single entity is critical to the success of cross-cutting projects, such as the operation of shared services centres and the Integrated Call Centre. And the successful letting of some private sector contracts requires the support of departments not directly involved in the service. For example, the Lands Department commonly plays a role in the approval of development projects.

***Being clear about the outcomes intended***

***Allowing 'non-conforming' contracts***

***Balancing contractual details with the freedom to innovate***

***Many issues go beyond departmental boundaries***

## Contracting for value

The best price does not always mean the lowest price. In the absence of specified outcomes and related management controls, low prices may lead to poor quality as contractors seek to protect their margins. Contracting and partnership arrangements built on a mutual recognition of value for money, rather than cost driven arrangements, are more likely to produce long term benefits for the community.

Opportunities also involve risks. When entering a contract with the private sector, the public sector may recognise and quantify some kind of risks for the first time. For example, risks to the level of demand for a service are rarely considered by the public sector, except under private sector contracts where the viability of the contract may rest on a minimum level of demand.

It is important that bureaux and departments guard against the possibility of the government sector being left with most of the risks in exchange for only a share of the benefits. The private sector sometimes assumes that the government will underwrite the risks. Recognising, allocating and managing the risks associated with private sector projects will remain a key responsibility of bureaux and departments.

For non-government organisations (NGOs) and charities, alternative contract arrangements may sometimes be appropriate. However, some grants given in the past have relied on extremely detailed specifications of inputs and outputs. As a result, staffing and terms of employment in many NGOs have been virtually the same as those in the civil service. This has raised their costs and given them no room to develop their distinctive cultures and character - which is what attracts some people to their services. It has also limited their scope for innovation.

Best practice suggests that contracts with NGOs and charities should be similar to contracts with the private sector, with arms-length relationships that allow for variation and innovation in the services provided.

## Monitoring for results

Monitoring is important to ensure the public interest is safeguarded, and that the terms and standards of a contract are maintained. Typically, the contractor should make a report on performance, which is independently checked for its coverage and accuracy.

Monitoring which is too detailed may choke a service by complexity, in the same way as over-prescription in a tender document or contract. The intentions of a flexible contract may be defeated also by too narrow an interpretation, the unwritten details of which become the effective contract. This may create unintended costs for the delivery of the service.

***Seeking value for money, not just the lowest prices***

***Recognising risks***

***Making sure government does not have most of the risks but only some of the benefits***

***Offering flexible grants to NGOs that give them scope to be alternative providers***

***The need for monitoring and the need for efficiency must be balanced***

Equally, being too zealous about the frequency of monitoring has costs. Too many surveillance occasions intrude on a supplier's operations and reduce its flexibility and profits. While monitoring of standards remains important, most important is a focus on whether results have been achieved. Performance should not be judged on sterile conformity with contractual inputs.

***Monitoring should focus on whether outcomes have been achieved, not inputs provided***

### Evaluating for the longer term

Evaluation differs from monitoring by being a periodic event rather than an on-going activity. But that is often the reason why it is overlooked.

Evaluation should always be undertaken when a contract is being relet, or when a policy is being reconsidered. It should cover all aspects of the service, not just those being provided by the private sector. It should reach more deeply than monitoring - asking not only 'are we doing things right?' but 'are we doing the right things?' It should test whether the desired results have been achieved and whether they remain the right goals to strive for.

***Evaluation is often the missing step - it looks at total results and asks if the goals remain relevant***

Because it goes further than monitoring, evaluation should normally consider longer term value for money, as well as efficiency in dealing with current issues and costs.

In addition, evaluation should build in the government's obligation to consider the likely desires, values and needs of future generations. The costs of evaluation are therefore normally borne by the government rather than being passed on to private sector suppliers.

***Evaluation considers the longer term, and the government bears that cost***

### Taking advice and guidance

Many forms of private sector involvement have already been used by the Hong Kong SAR Government. Nonetheless, experience and knowledge is varied throughout the service and there is much that can be learned both from each other and from overseas.

The Efficiency Unit/Management Services Agency are charged with coordinating the development of government capabilities in this area.

- An Assistant Director post has been established to provide guidance on the wider issues of private sector involvement (Tel: 2810 3463).
- A help desk on outsourcing has been set up within MSA (Tel: 2165 7255).
- Practical guides are being developed and trialled.

## Options for involving the private sector

The range of strategies or initiatives that involve the private sector set out below are not exclusive options. They can overlap and interchange.

### *Purchaser/Provider Agreements cover:*

Contracting in		
<b>Definition:</b> using private sector staff or expertise under in-house management, in order to supplement the resources of the department.	<b>Opportunity:</b> to add to the department's ability to deliver outputs immediately, when pressure is intense. Contracting in can manage the risk that there will be insufficient resources to meet unpredictable or growing service needs.	<b>Challenge:</b> to ensure that in-house staff and expertise are not neglected, and that future supply is safeguarded through well managed contracts.
Contracting out/Outsourcing		
<b>Definition:</b> contracting with an external party to provide specified services over an agreed timeframe.	<b>Opportunity:</b> to improve service quality by accessing private sector skills, innovation and technology; to allow government to concentrate on priorities; to more rapidly deliver new services to the community and capitalise on new opportunities.	<b>Challenge:</b> to contract for outcomes and value for money, not just inputs and lowest price; to maintain sufficient control over the contract through monitoring results without stifling the contractor's initiative.
Grants and Subventions		
<b>Definition:</b> payment of a one-off sum or renewable lump sum to a private sector organisation or NGO to provide a service.	<b>Opportunity:</b> to augment the department's power to deliver a service through using agents who have expertise in dealing with similar clients.	<b>Challenge:</b> to ensure that the conditions for the grants allow the outside organisations to maintain its brand character, and to operate practices such as using voluntary staff. At the same time, conditions should be sufficiently specific to enable monitoring of outputs or outcomes.

## Public/Private Partnerships cover:

Creating wider markets		
<p><b>Definition:</b> launching new initiatives using private sector skills and finance to utilise the assets of the public sector, both physical and intellectual. (An example from the United Kingdom is the deal between the private sector body, Cardington, and the Public Record Office, which aims to mount money earning exhibitions using the PRO's huge resources of ancient and intriguing records.)</p>	<p><b>Opportunity:</b> to exploit the potential of assets, which cannot easily be sold, and to share in the returns.</p>	<p><b>Challenge:</b> to identify where such potential exists, and to ensure that the taxpayer receives a fair share of the returns.</p>
Private finance initiatives		
<p><b>Definition:</b> the public sector contracts to purchase quality services, with defined outputs, on a long-term basis. This includes the private sector maintaining or constructing the necessary infrastructure. The term also covers financially free-standing projects where the private sector supplier designs, builds, finances and then operates an asset and covers the costs through direct charges on the users of the asset. Public sector involvement is limited to assistance with planning, licensing and other statutory procedures.</p>	<p><b>Opportunity:</b> to benefit from private sector innovation, to generate innovations in the design and operation of assets, and to take advantage of private sector commercial disciplines to modernise services and obtain better value.</p>	<p><b>Challenge:</b> to define the requirements on the private sector partner from the start (for example through a clear performance regime), and to ensure there is an appropriate allocation of risks between the public and private sectors.</p>
Joint ventures		
<p><b>Definition:</b> partnerships in which public and private sector partners pool their assets, finance and expertise under joint management, to deliver long term growth in value for both partners.</p>	<p><b>Opportunity:</b> to exploit the latent potential of government assets, and share the risk of delivering policy objectives and commercial objectives. Joint ventures can include contractual agreements such as licenses, profit and revenue sharing agreements, or formal corporate ventures.</p>	<p><b>Challenge:</b> to judge when to use joint ventures rather than more conventional partnerships, and to create the right balance of risks and rewards for the public and private sectors. Structures need to work commercially, and be sufficiently robust to withstand public scrutiny.</p>



Partnership companies		
<p><b>Definition:</b> introducing private sector ownership into state-owned businesses, while preserving the public interest and public policy objectives, through legislation, regulation, partnership agreements, or retention of a special government share.</p>	<p><b>Opportunity:</b> to bring in the benefits of private sector ownership, including private sector investment and management skills.</p>	<p><b>Challenge:</b> to safeguard any continuing public sector interest in such assets, and to ensure the taxpayer receives value for money.</p>
Partnership investments		
<p><b>Definition:</b> partnerships in which the public sector contributes to the funding of investment projects by private sector parties, to ensure that the public sector shares in the return generated by these investments.</p>	<p><b>Opportunity:</b> to overcome market failure by providing finance for projects with commercial potential. Usually, the size, risk, or timescale of the investment, or the political context, mean that the capital markets are unable to fund fully the costs. Partnership investments allow the taxpayer to share in the future returns from the project.</p>	<p><b>Challenge:</b> to ensure that such investments offer value for money. In particular, that the terms of the investment provide the public sector with returns commensurate with the risks it is taking on.</p>
Franchises		
<p><b>Definition:</b> a concession awarded by the government to a private sector organisation to provide a public service for an agreed period. The private sector organisation pays a fee during this period for the revenue (or a share of the revenue) that the service generates.</p>	<p><b>Opportunity:</b> to maintain ownership, but use the private sector to deliver services efficiently.</p>	<p><b>Challenge:</b> to define the standards of service provision that ensure good coverage and quality of service but also the opportunity for the private sector to profit by innovative efficiencies. Further, to apportion the risks of poor performance so that government is not left with most risks but relatively fewer benefits.</p>

## Privatisation covers:

Asset sales or transfers		
<p><b>Definition:</b> the sale or transfer of surplus public sector assets.</p>	<p><b>Opportunity:</b> to release the potential of public sector assets by exploiting private sector finance, management, and other skills and capabilities.</p>	<p><b>Challenge:</b> to safeguard any continuing public sector interest in such assets, and to ensure the taxpayer receives value for money.</p>
Sales of shares in state enterprises		
<p><b>Definition:</b> the sale of shares in state-owned businesses, by flotation or trade sale. This can be either the sale of a minority stake or a majority stake.</p>	<p><b>Opportunity:</b> to improve management performance through private sector investment and capital market disciplines and thereby release the potential of state-owned businesses.</p>	<p><b>Challenge:</b> to ensure benefits are shared fairly with employees, customers and taxpayers by establishing effective competition, regulation or other mechanisms to protect the public interest; linking the timing of the sale to progress in meeting targets associated with growth of shareholder value; and providing incentives to improve performance in the run up to the sale and beyond.</p>
Management buy outs		
<p><b>Definition:</b> where the employees of a department raise the finances to buy the assets and establish an independent business to provide the service. This is commonly led by management but can involve all employees.</p>	<p><b>Opportunity:</b> to build on existing expertise, operational practices and customer loyalties but shift service provision to the private sector. The private sector grows by the addition of a new player, without loss of employment for staff.</p>	<p><b>Challenge:</b> the clear challenge is for the new business to be competitive, which may require changes to its current modes of operation and conditions of employment. The risk that the public may see the new business as 'underwritten' by government needs to be managed.</p>



*Private Sector Provision covers:*

Market provision of services		
<p><b>Definition:</b> the private sector meeting a defined community need without direct recourse to public funds or other public resources.</p>	<p><b>Opportunity:</b> to encourage or enable the private sector to directly meet a community need, often by removing regulatory constraints, social funding arrangements or changing the competitive environment.</p>	<p><b>Challenge:</b> to ensure that both users and the competitive environment are protected through appropriate regulation without stifling the efficient and innovative provision of the service.</p>
Withdrawal of public services		
<p><b>Definition:</b> winding up a public service where demand is being adequately met by alternative private sector providers.</p>	<p><b>Opportunity:</b> to reduce both public expenditure and burdens on public sector managers.</p>	<p><b>Challenge:</b> to redeploy current staff and assets.</p>

The booklet has been prepared by the Efficiency Unit with assistance from **PRICEWATERHOUSECOOPERS** ■

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THE GOVERNMENT OF THE HONG KONG SPECIAL ADMINISTRATIVE REGION