

**For discussion on
21 February 2011**

**Legislative Council Panel on Public Service
Use of Outsourcing in the Delivery of Government Services**

Purpose

This paper reports to Members on findings from the latest review on outsourcing activities across the Government and on measures being taken to ensure that outsourcing arrangements are properly designed and managed.

Background

2. Four principles apply to the management of all public services:

- Being accountable
- Living within our means
- Managing for performances
- Developing a culture of service

Within this management framework, decisions are taken as to how particular services are to be provided. Public service managers are expected to review the services for which they are responsible regularly. The aim is to ensure that resources are being well used to provide services that address real needs in an effective manner.

3. Outsourcing is one option that can be considered as a means to provide public services. It gives flexibility and can help to bring in external resource and expertise that stimulate efficiency and effectiveness in the provision of services. As with all other options for providing services, care is needed to determine whether outsourcing is appropriate in each particular circumstance. Careful attention must also be given to the design and negotiation of contracts to ensure that these are properly structured to achieve necessary outcomes in terms of service performance, customer service and management of staff. This must be followed up with effective performance measurement and enforcement. Accountability for the service remains with the public service manager.

4. Local and international experience demonstrates that well prepared, implemented and monitored projects using the private sector can bring significant benefits to the Government and the community, including:

- enhanced service quality and value for money;
- increased capacity in the provision of new or expanded public services;
- strengthened civil service management focus on core services and effective resource utilisation; and
- development of the wider economy, with the promotion of private sector job creation and development of experience and expertise.

5. To help public service managers assess whether outsourcing is appropriate in any particular case, to help develop effective contracts and to manage their operation effectively, the Efficiency Unit, in addition to providing advisory services, has produced a number of best practice guides. The key documents are:

- The Government Business Case Guide
- A General Guide to Outsourcing
- A User Guide to Contract Management
- A User Guide to Post Implementation Reviews

Annex I

A brief outline of the purpose of these and other relevant guides is at Annex I.

6. The Civil Service Training and Development Institute has provided an extensive range of training programmes to help Departments develop capacity to design and manage outsourcing contracts. The Efficiency Unit has surveyed experience in other jurisdictions and shared lessons through a report “Competition and Contracting: Learning from Past Experience”.

7. Since 2000 the Efficiency Unit has conducted six surveys on outsourcing activities across Government, to identify trends and issues that need attention. The following paragraphs highlight the major findings from the latest survey carried out in 2010.

The 2010 Outsourcing Survey

8. The survey provides an overview of outsourcing activities by Government

Departments as at 1 July 2010.

Figure 1

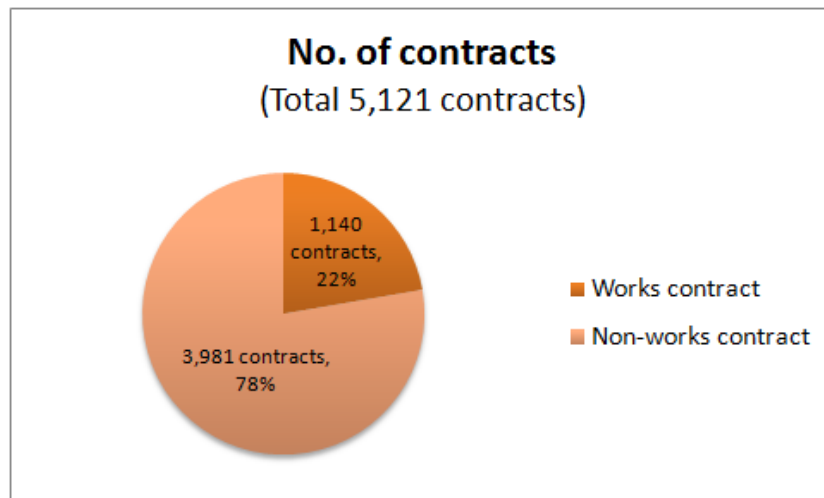


Figure 2

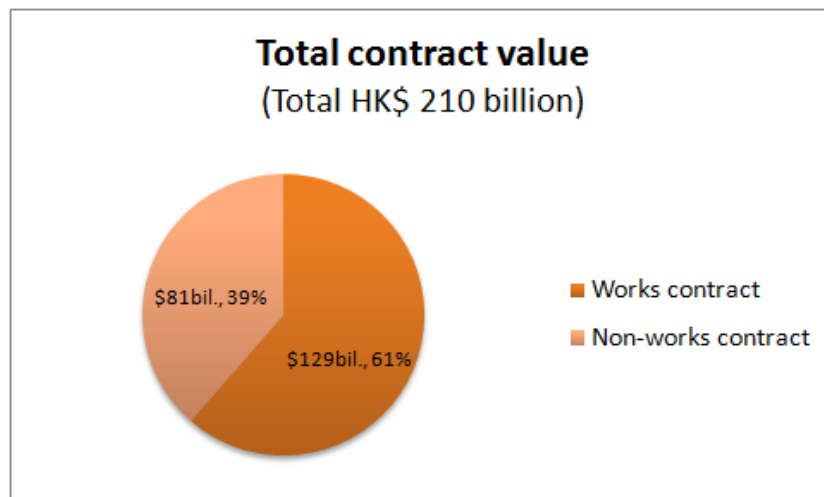
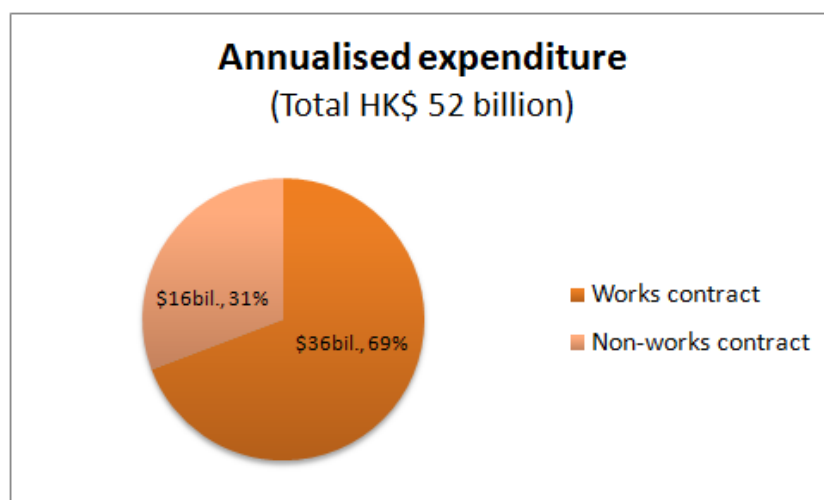


Figure 3



9. Figures 1 to 3 above show the number and broad allocation of outsourcing

contracts, the total value of such contracts and the annualised¹ expenditure arising from them.

10. The annualised expenditure on outsourcing is equivalent to 16% of the HKSARG's 2010-11 total estimated expenditure. The value of outsourcing activities, in terms of annualised expenditure had increased by about \$10 billion from the position recorded in the 2008 survey. The rise was mainly due to a \$7.7 billion increase in annualised expenditure on works contracts. Figure 4 shows the changes in the pattern of Government outsourcing activities since 2002.

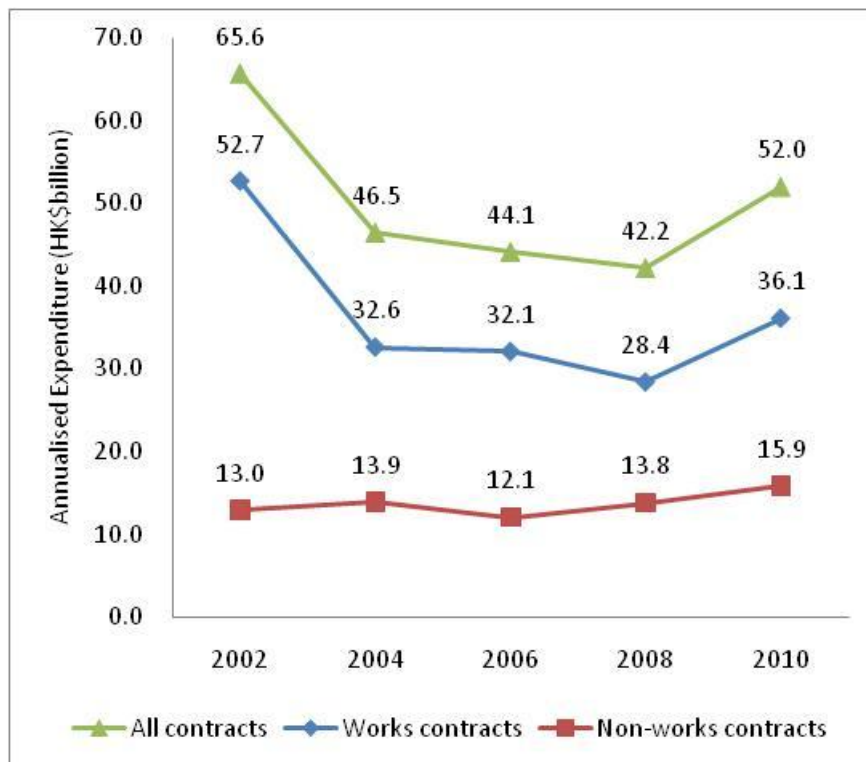


Figure 4: Trend in Government Outsourcing Activities

11. The general profile of outsourcing at 1 July 2010, compared with 2008 and 2006 is set out in Figure 5 below. Notable changes are the increase in the number of contracts and the decrease in the average contract value, especially for non-works contracts.

¹ The annualised expenditure for an outsourcing contract is estimated based on the contract value divided by its duration.

	Non-works contract				Works contract			
	2006	2008	2010	2010 vs 2008	2006	2008	2010	2010 vs 2008
No. of contracts	3,048	3,296	3,981	+21%	936	1,043	1,140	+9%
Contract value (\$M)	73,117	84,992	81,186	-4%	134,739	130,830	128,747	-2%
Avg. contract value (\$M)	24	26	20	-21%	144	125	113	-10%
Annualised expenditure (\$M)	12,065	13,799	15,897	+15%	32,075	28,388	36,079	+27%
Avg. annualised expenditure (\$M)	4.0	4.2	4.0	-5%	34.3	27.2	31.6	+16%

Figure 5: Outsourcing Profiles of 2006, 2008 and 2010

12. Over 80% of the annualised expenditure on outsourcing was for capital works and construction, building and property management, and environmental hygiene contracts. Figure 6 shows the top five service categories that account for 90% of the total annualised expenditure. This pattern has not changed since 2008.

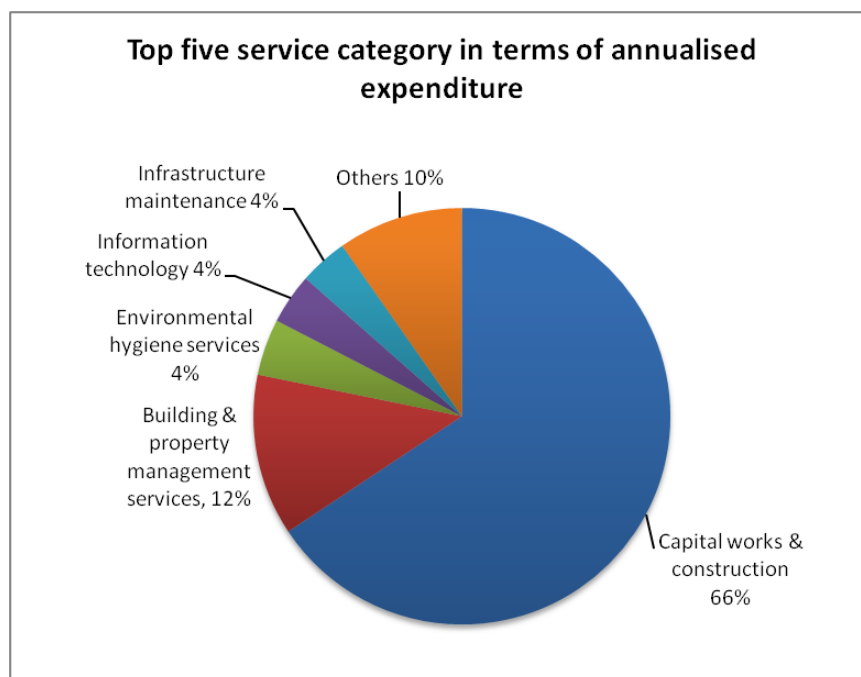


Figure 6: Distribution of Annualised Expenditure by Outsourcing Service Categories

13. In terms of distribution by departments, Architectural Services Department (39%), Housing Department (19%), Drainage Services Department (10%), Highways Department (7%) and Civil Engineering Development Department (3%) account for 78% of the annualised expenditure. Again this pattern is the same as in the 2008 survey.

14. Other findings from the 2010 survey are:

- Setting aside works contracts², the majority of responding departments reported estimated savings in the region of 26% to 34%.
- The average management and monitoring cost estimated by departments was 11% of the annualised contract value, similar to that reported in 2008.
- 78% of departments report challenges in monitoring service delivery and compliance. This represents 10% points increase from 68% in 2008. Other major challenges reported by departments include performance evaluation and reporting (69%) and enforcing performance against service levels (65%). Again, both these figures have increased by about 10% points since the last survey.
- 88% of all departments indicated that all or most of their outsourcing contracts were completed on time and within budget. This represents an 11% points improvement from the 77% reported in 2008.

15. Outsourcing is a management tool to help achieve the provision of public services in sufficient quantity, to sufficient quality and in accordance with essential standards. It is not an objective in its own right. As noted in paragraph 3 above, if outsourcing is to achieve beneficial purposes, consistent with public interest, careful attention must be given to the circumstances in which outsourcing is used, the way that contracts are structured and the ongoing oversight and review of performance. Services may be outsourced but public service managers retain the responsibility to ensure the quality and conduct of the service. The following section outlines steps that have been taken to address particular concerns about the operation of outsourcing contracts.

Protection of non-skilled workers

16. In the early 2000s, a number of cases were found where non-skilled workers

² Since the Government has never used in-house staff to deliver infrastructural projects which constitute the bulk of works contracts, it is not possible for departments to estimate the savings from using outsourcing contracts compared with in-house expenditure in such cases.

employed by outsourcing contractors were paid very low wages.

17. Since 2001 various measures have been taken to address this. Contractors under Government service contracts are required to make use of the fixed monthly wage rates as the basis for payment of salary to non-skilled workers. The requirement also applies to service contracts in respect of the supply of non-skilled agency workers. In May 2004, Government introduced a mandatory wage level requirement for its contracts. A tender offer shall not be considered if the monthly wages offered by the tenderer to its non-skilled workers are less than the average monthly wages for the relevant industry/occupation as published in the latest Census and Statistics Department's Quarterly Report of Wage and Payroll Statistics at the time when tenders are invited.

18. In March 2005, the Administration introduced a standard employment contract for non-skilled workers for use by contractors of government service contracts. The 2010 Outsourcing Survey shows that departments responsible for 48% of the number and 82% of the value of outsourcing contracts were making use of the standard employment contract for non-skilled workers in the specifications of all or most of their service contracts. This is not a significant increase over 2008.

19. Government departments adopt various measures to check whether the committed wage level for non-skilled workers are honoured by the contractors concerned. Such measures include standard salary statements, surprise checks, and dedicated complaint hotline for workers employed by outsourced contractors to lodge complaints on any exploitation of wages and work-related benefits³. Breaches are monitored closely through a service-wide Demerit Point System (DPS). Offenders may be barred from bidding for further Government service contracts. Figure 7 shows the position with respect to wages related breaches of contract cases since 2005.

³ For example, the Leisure and Cultural Services Department (LCSD) holds regular meetings between the headquarters contract management team and the senior managers of the contractors to appraise the latter's performance and exchange views on contract management issues and related policies. These meetings serve as a forum by which the Department enhances mutual communication and conveys a message of zero tolerance for the exploitation of non-skilled workers. The LCSD has also implemented a computerised appraisal system that provides an overview of contractors' performance trends. (2009-10 LCSD Annual Report).



Figure 7: Cases of Contractual Obligation Breached⁴

20. To raise awareness and help departments to avoid risks of labour exploitation, the “User Guide to Contract Management” includes a number of recommendations. These include the monitoring of contractors and collaboration with law enforcement agencies (e.g. Labour Department, MPFA etc) to ensure that contractors comply with all regulatory, statutory and contractual requirements. Departments are also advised to increase the transparency of employment-related information, provide relevant information to contractors’ employees and establish channels, such as direct enquiry hotlines, for them to report any contractors’ malpractices.

Service quality of outsourcing contracts

21. The risk of deterioration of quality of an outsourced service needs to be understood and addressed in the design and management of contracts.

22. The 2010 Outsourcing Survey indicates that, overall, departments are adopting various measures and management tools to monitor service quality. These include provisions for performance monitoring mechanisms and review as well as use of service level agreements. Figure 8 shows the methods adopted by department in

⁴ Source: Consolidated List of Service Contractors which have been issued with Demerit Points on Government Logistics Department’s web site. The period covered is from 01.04.2005 to 31.12.2010. 1 case = 1 DPS point.

monitoring the service quality of contractors.

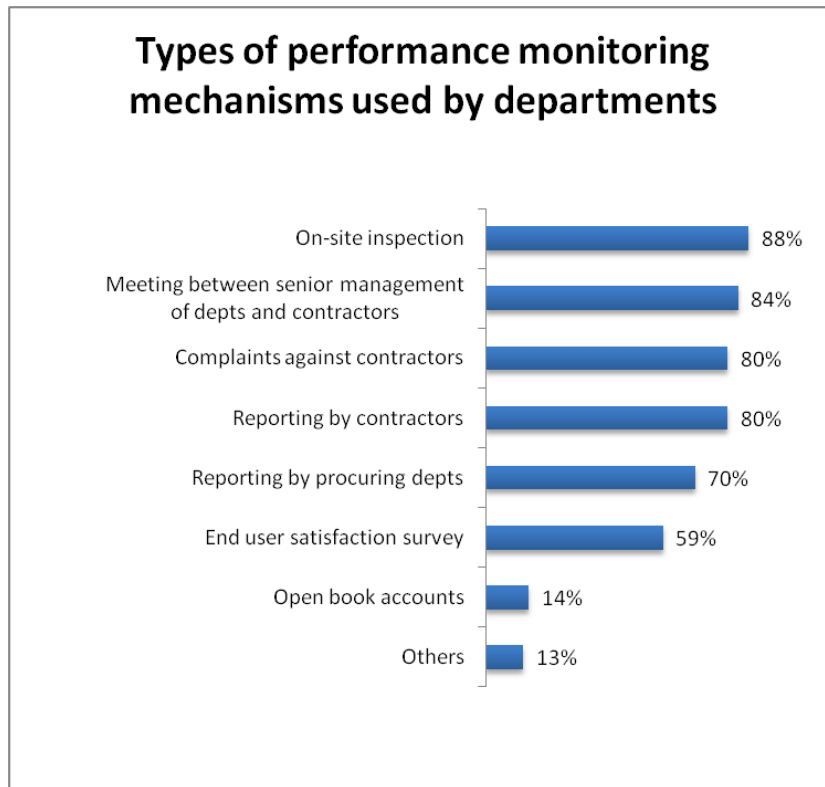


Figure 8: Performance Monitoring Mechanisms used by Departments

23. The “General Guide to Outsourcing” and the “User Guide to Contract Management” recommend the use of service level agreements so that departments can define clearly the service standards expected from the contractors on dimensions such as point of delivery, availability, reliability, response time etc. They set out other steps that can be taken to improve or sustain quality of service over the life of a contract. Evaluation to determine whether the business case for outsourcing remains valid and, if so, whether the contract terms need improvement before any new contract is let is also recommended. The 2010 Outsourcing Survey indicates that when contracts are approaching expiry, 91% of departments identify learning points and improvements to apply to any new contract, 72% re-assess the business case.

Cost effectiveness

24. A number of questions have been raised over the years as to whether outsourcing is cost effective after taking into account of contract management costs and effort incurred to rectify any outsourcing problems (e.g. non-performance of contractor). There has been particular concern that, while reducing cost is not the

only objective for outsourcing, the practice may be to seek lowest cost over other considerations.

25. The Outsourcing Survey provides some information relevant to this question. Estimated savings and costs of contract management have been reported as noted in paragraph 14 above. The survey also showed that cost reduction had fallen from 6th to 10th place in the ranking of reasons given for undertaking outsourcing.

26. The Government's objective in any contract is achieving value for money for the public. That requires attention to the quality of service to be provided as well as attention to cost. To achieve this end, a 'two-envelope' approach to tender evaluation is advocated. Sufficient weighting should be given to the technical and quality requirements to ensure that all conforming tenders would meet the technical standards required. These must be assessed before consideration is given to price. These principles are underlined in the "General Guide to Outsourcing" and "User Guide to Contract Management". The 2010 Outsourcing Survey shows that over 85% of departments are adopting the 'two-envelope' approach in tender evaluation. The 2010 survey also finds that the most common technical weightings are adopted by departments are between 20% - 40%. 95% of departments consider the bidders' past performance in tender evaluation.

Staff response to outsourcing

27. The 2010 Outsourcing Survey finds that only 2% of the departments indicated that they have deleted posts affected by outsourcing in all cases. The majority (85%) of department considered that outsourcing has no or little impact on deletion of posts (Figure 9). If there are staff affected by the outsourcing contracts, the departments concerned would normally redeploy the affected staff, some for contract management, the rest to other duties.

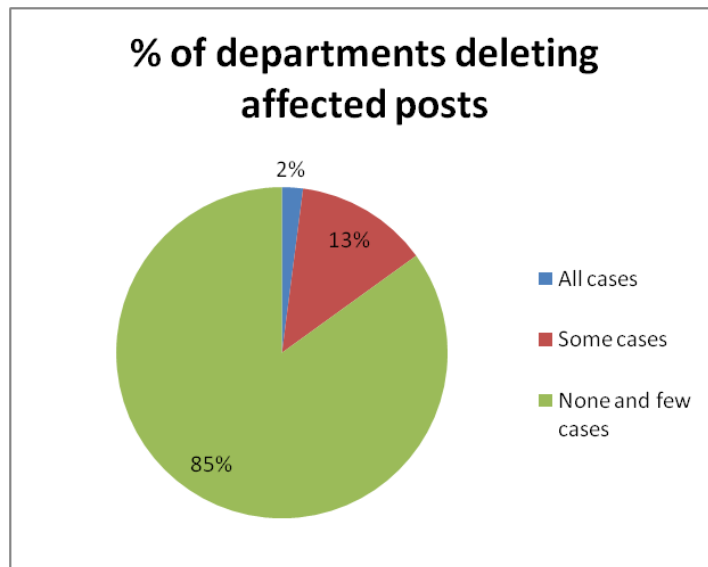


Figure 9: Deletion of affected post due to outsourcing

28. It is the government policy that no staff will be made redundant due to contracting out. Although the number of outsourcing contracts increased significantly between 2008 and 2010 the civil service establishment level also increased over the same period. While some staff have been redeployed to work in contract management, others have been freed up for deployment to other core services.

29. In the Survey, departments were asked to consult their staff on their views to outsourcing. 84% report that their staff accepted the changes brought about from the outsourcing of in-house service. Only 2% of staff strongly objected to outsourcing of services (2008 survey was 3%).

30. The “General Guide to Outsourcing” highlights the requirements to consult staff on proposals for new outsourcing project and take full account of any impact on them. The “Government Business Case Guide” underlines the requirement that departments should formulate a communication strategy when the business case for any new initiative is being evaluated. The purpose is to help departments to communicate with the major stakeholders, which include their staff, early in the project so that their needs and issues can be properly addressed.

The way forward

31. The Efficiency Unit will continue to give support to departments on outsourcing through publication of best practice guides, conducting training courses,

and providing advice. We will be following up on findings from the 2010 survey. In particular we will:

- (a) Seek to further extend use of the business case tool and post implementation review by departments;
- (b) Explore further into the reasons for the increased challenges departments reported;
- (c) Examine further the reasons for the increase in number and decrease in value of non-works contracts;
- (d) Promote wider use of standard employment contracts for non-skilled workers; and
- (e) Review with the Civil Service Training and Development Institute the provision of training programmes on design and management of outsourcing contracts.

We will conduct another survey in 2012 to obtain further data to assist evaluation of the use of outsourcing contracts and sustain attention to good practice so as to achieve outcomes of public value.

Efficiency Unit
February 2011

List of Relevant Guides and Reports Issued by the Efficiency Unit

**Serving the Community by Using the Private Sector - Policy and Practice
(2nd edition, January 2007)**

<http://www.eu.gov.hk/english/publication/pub_bp/files/PolicyPractice2007.pdf>

- This edition of the general guide to using the private sector to deliver government services drew together practice that had developed to ensure fair employment and protection of workers' rights.

A General Guide to Outsourcing (3rd edition, March 2008)

<http://www.eu.gov.hk/english/publication/pub_bp/files/guide_to_outsourcing_200803.pdf>

- Advises on the key steps of outsourcing. Special emphasis has been given to contract renewal since outsourcing has reached a mature stage where the majority of outsourcing activities concern renewal of existing contracts.
- Highlights that departments remain accountable for the outsourced services – “*one can outsource the responsibilities but never the accountability*” (p.2)
- Other best practices advocated include appropriate levels of service, sufficiently long contract duration, robust tender selection, avoidance of selection of tenderers simply on the basis of lowest price tender, review of existing contract before re-use; outcome-based specifications.

A User Guide to Contract Management (1st edition, February 2007)

<http://www.eu.gov.hk/english/publication/pub_bp/files/cm2007.pdf>

- Supplements the *Policy and Practice* guide and *General Guide to Outsourcing* by addressing the challenges that need to be dealt with during different stages of the outsourcing. The intention is to help civil servants with the transformation from the role of an in-house service provider to that of effective contract managers.

- The guidance includes –
 - Proper allocation of roles in departmental headquarters, branch offices, etc in different stages of outsourcing (e.g. business case development, tendering and selection and contract management)
 - Selection of the optimum business model (e.g. scope of outsourcing) and development of commercially viable arrangements (e.g. pricing model, bundling services in a single contract)
 - Development of high quality procurement documents (e.g. consider the worst case scenarios such as service failure) and tender marking schemes (e.g. “two-envelope” approach, check previous conviction records and demerit point records, conduct due diligence)
 - Management of the contractor relationships (e.g. appropriate governance structures and processes)
 - Encouragement of good practices from contractors (e.g. posting notices on employment conditions at sites, setting up hotlines on labour exploitation, partnering with relevant authorities to combat malpractices)

A Government Business Case Guide (1st edition, May 2008)

<http://www.eu.gov.hk/english/publication/pub_bp/files/Business_Case_Guide.pdf>

- A Government Business Case is a detailed and structured proposal for improvement in terms of costs, benefits and risks, that justifies changing the way that a particular aspect of government business is conducted. The main stages of a business case study include analysis of requirements, options selection and evaluation, and implementation planning (e.g. timing, resources, budget and implementation issues such as environmental, legislative or regulatory impacts).
- Departments are advised to conduct a rigorous examination of whether a project should proceed or not, and identify the best option for project delivery. One possible option may be to use the private sector. Other findings may be that provision through different forms of public service bodies or subvented agencies are appropriate, or that there are no acceptable or viable options for delivering a proposed project.

A User Guide to Post Implementation Reviews (1st edition, February 2009)

<http://www.eu.gov.hk/english/publication/pub_bp/files/pir.pdf>

- A post implementation review (PIR) evaluates whether the project/programme has achieved its intended objectives, reviews the performance of project management activities and captures learning points for future improvements.
- The guide advises departments on how to review projects/programmes, including outsourcing projects, to assess their achievements and identify improvement opportunities. It helps departments make the best use of public resources, demonstrate accountability and learn from experience.
- PIRs may be conducted during the project implementation stage, and/or after project closure.
- Departments are advised to develop actionable recommendations with a view to bringing about future improvement. The recommendations may involve changes in project strategies, project plan, expansion/reduction of the project scope, or even termination of the project.

PSR Report – Competition and Contracting: Learning from Past Experience (January 2008)

<http://www.eu.gov.hk/english/publication/pub_bp/files/learn_past_exp.pdf>

This report and accompanying seminar:

- Provides learning points by highlighting the acts and omissions during the design and management of public service contracts in overseas that can lead to outsourcing contract failures.
- Illustrates “exemplary failures” in various aspects of the outsourcing were studied, including procurement design, managing the procurement, contract design, contractual accountability, contract management and market design.