

Introduction

4.001 We have looked at contracting in local government in a number of reports over the past few years:

- In our 1997 report *Contracting for Maintenance Services in Local Government*, we looked at how five local authorities were managing major contracts for maintaining key assets and community facilities.¹
- In 1998, we reported on Papakura District Council entering into a franchise agreement for running its water and wastewater services.² We describe in Part 5 of this report (pages 131-160) how the Council is managing and monitoring the agreement.
- In 1999 we reported on *Contracting Out Local Authority Regulatory Functions*, prompted by Queenstown Lakes District Council contracting with a private sector contractor for the performance of most of its regulatory functions.³

4.002 The purpose of this article is to provide some useful information for any local authority considering entering into a long-term contract for services – with particular reference to maintenance services. The article is not intended to be comprehensive, but as general guidance only. Our reports on the water and wastewater franchise at Papakura District Council – both in 1998 and in Part 5 of this report – also provide lessons about longer-term relationships.

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Queenstown's Experiences

- 4.003 Queenstown Lakes District Council (QLDC) has a history of contracting with private sector contractors – including for maintenance services, regulatory functions, property management, and refuse disposal (in partnership with Central Otago District Council).
- 4.004 For maintenance services, QLDC changed some time ago from in-house provision to external supply under a contract with a private contractor – Lakes Contract Services (LCS). The contract with LCS resulted from a management buy out involving QLDC's former works manager, and was not tendered. The contract has several years to run.

Proposed Total Maintenance Management Contract

- 4.005 In 2000, QLDC and LCS discussed entering into a longer-term “partnering” type contract for maintenance services, described as Total Maintenance Management (TMM). QLDC asked us for some assurance as to the soundness of its evaluation and decision-making processes.
- 4.006 QLDC intended not to tender the TMM contract but to negotiate it directly with LCS.⁴ Both parties wished to enter into a long-term contract, and a term of up to 30 years (based on the life span of the water and sewerage infrastructure) was considered.
- 4.007 QLDC later decided not to proceed with a TMM contract with LCS. Nevertheless, we thought it would be useful to outline what QLDC intended to achieve and describe the process it followed, as well as comment on issues arising. We hope that this will provide some guidance to any other local authorities intending to enter long-term service contracts.

⁴ Because the existing works contract with LCS had several years to run, QLDC could not tender for a new contract without LCS's agreement.

Scope of the Contract

- 4.008 The scope of the proposed TMM contract covered water and wastewater, parks and reserves, street lighting, and other works functions (excluding subsidised roading). The key components of the TMM contract were to be:
- an outcome-based specification;
 - QLDC to retain ownership of assets, but risks usually associated with ownership would be transferred to LCS, as would “stewardship” of the assets, in return for a longer-term contract based on a “partnering relationship”;
 - LCS being responsible for investing in and managing QLDC assets, including replacing and upgrading infrastructure, as well as ongoing maintenance;
 - LCS being responsible for paying for all costs of maintenance and replacement in return for regular payments to LCS by QLDC throughout the life of the contract; and
 - the position of subcontractors being protected (a joint QLDC-LCS tenders panel would allocate work to subcontractors).

Steps Taken by QLDC

- 4.009 As at February 2001 QLDC had:
- Received some preliminary advice from its solicitor on competition considerations and from its Chief Executive on the requirements of the Local Government Act 1974 (the Act).
 - Made contact with the Commerce Commission.
 - Outlined the proposed TMM contract to various business representatives (including both business associations and private developers) and local contractors and subcontractors.
 - Made available to the public the papers that were being presented to the Council on the proposed TMM contract and the progress QLDC was making in working out the details of the arrangement.

- Developed outcome measures for the proposed TMM contract in conjunction with LCS. For example, for parks and reserves LCS was to be required to ensure that any park chosen at random during monitoring would be up to the standard of the “model” park. Outcome measures were to be assessed by an independent adviser to avoid risk of ‘contractor capture’.
 - Formed subgroups to work on certain matters such as pricing and asset management plans.
- 4.010 LCS had done some work on existing valuations and asset management plans. LCS also intended to seek expert advice on issues affecting pricing the contract.

Our Advice to QLDC

- 4.011 We reported to QLDC on the process that it was following, based on our expectations on certain topics. Our overall view was that QLDC had a good understanding of the amount and complexity of the work it faced to implement the proposed TMM.
- 4.012 In the following paragraphs we summarise and update the advice we gave to QLDC. What we say is not necessarily exhaustive, and a local authority considering entering into a long-term service contract will need to identify and address itself to all factors relevant to its proposed contract.

Legal Considerations

Expectation

- 4.013 We expect the local authority to be able to demonstrate that it has analysed the legal issues and legal risks involved, and sought expert advice as necessary, particularly in relation to:
- its obligations under the Act, including the requirements of sections 247D and 247E;
 - the liability for the performance of a specific function;

- the contractor's employees needing to exercise any of the authority's enforcement powers;
- the authority being appropriately indemnified against the contractor's failure to perform or negligence; and
- the proposed term of the contract, including any implications of the Commerce Act 1986.

Statutory Obligations

- 4.014 Section 247D of the Act requires a local authority to consider the advantages and disadvantages of different options for contracting out services and functions as opposed to using its own staff.
- 4.015 Section 247E of the Act requires a local authority to consider whether to put to tender any contract that is likely to involve it in expenditure or financial commitment that the authority regards as significant. Should the authority decide not to put a contract to tender, it must record its reasons in writing.
- 4.016 In making decisions under both sections 247D and 247E a local authority must have regard to:
- its objectives, as stated to the public in its annual plan; and
 - in the case of section 247D, the requirements of section 223C of the Act.⁵

Delegation of Powers

- 4.017 Should a contractor's employees need to exercise the local authority's enforcement powers the authority will also need to consider any legal issues arising from that need. For a discussion of those issues see our report *Contracting Out Local Authority Regulatory Functions*.⁶

⁵ Section 223c concerns the conduct of local authority affairs and includes the requirements that local authorities conduct their business in a manner that is comprehensible and open to the public; that clear objectives are established for each activity and policy; and that local communities are adequately informed about local authority activities.

⁶ Paragraphs 631, 637-639, and Appendix B.

Competition Considerations

- 4.018 QLDC intended not to tender the TMM contract but to award it to the existing contractor. A term of 30 years was discussed. QLDC intended to meet with Commerce Commission staff to discuss the proposed contract.
- 4.019 The purpose of the Commerce Act 1986 is to promote competition in New Zealand markets. The Commerce Commission is an advisory and regulatory body under that Act.
- 4.020 Section 27 of the Commerce Act prohibits a local authority from entering into a contract that has the purpose, or has or is likely to have the effect, of substantially lessening competition in a market (one of several “restrictive trade practices” under the Act). It is illegal to enter into a contract that substantially lessens competition.
- 4.021 The Commerce Commission can issue a warning or reach a settlement with a person in breach, or seek to have the person prosecuted in the High Court. A body corporate can be fined up to \$5,000,000 for a restrictive trade practice.⁷
- 4.022 The Audit Office has limited expertise in competition matters. However, we considered that the proposed TMM contract could have the effect of shutting out potential maintenance contractors in the QLDC district for a long period, thereby lessening competition in the market for maintenance services. However, the contract would not affect the subcontractor market as subcontractors were still able to tender for work under the proposed TMM contract.
- 4.023 We met with a Commerce Commission Chief Investigator in preparing this report. The Chief Investigator told us:
- A decision not to tender a contract is not necessarily relevant to the Commerce Commission (the Commerce Act does not require that contracts be tendered).
 - The length of the contract is relevant to competition considerations. In considering whether a contract is anti-competitive, the Commission needs to consider the nature of the market in the area and the effect on that

⁷ Section 80 of the Commerce Act 1986.

market over the proposed length of the contract. If a contract shuts out other contractors for a considerable period it may be more likely to substantially lessen competition than a contract for a shorter period.

- In considering the nature of the market for providing maintenance services in the Queenstown district, the Commission would consider the position of potential contractors. In considering the proposed TMM contract, the Commission would have considered the geographical extent of the market, i.e. whether potential maintenance contractors could operate in other areas besides Queenstown over the next 30 years. If so, awarding a contract to a local firm may not *substantially* lessen competition. Whether the TMM contract would represent a substantial part of the market for maintenance contracting in the market area would also be relevant.
- If a local authority believes that a contract may substantially lessen competition, it may apply to the Commerce Commission for an authorisation under section 58 of the Commerce Act. That section allows the Commission to grant an authorisation for a contract that substantially lessens competition, if it is satisfied that the benefit to the public outweighs the lessening of competition in the circumstances. In assessing public benefit, the Commission has regard to efficiency improvements and looks for true benefits (in the local authority context, net gains to ratepayers) not just redistribution of wealth. The expected duration of any benefit is relevant.
- The Commerce Commission can advise a local authority on whether any proposed contract may substantially lessen competition and, if so, what action the Commission might take. (The fee for an authorisation is currently \$12,000.) The granting of an authorisation protects the applicant from action by the Commission or private individuals over the contract, and the process from application to decision takes 60 working days.

4.024 We suggest that a local authority intending to enter into a long-term contract seek early advice from a competition law specialist on the Commerce Act implications.

Consultation

Expectation

- 4.025 We expect the local authority to carry out sufficient consultation to satisfy itself that it has identified the needs, issues and any concerns of stakeholders. The results of the consultation should be clearly documented and used in the decision-making process.⁸
- 4.026 Stakeholders should be given the opportunity directly to comment on any proposal. The stakeholders include the public, the business sector in general, and subcontractors in particular.

Consulting the Public

- 4.027 The public has to be able to understand a range of reasonably complex issues associated with a long-term contract. For example, with the proposed TMM contract the public needed to understand what QLDC described as “stewardship”. QLDC meant by this that the contractor would “look after” the assets (such as the total water supply network) for the life of the contract – including those assets that the contractor built or repaired during the contract – but would not own those assets.
- 4.028 A local authority wishing to have such a “partnering relationship” with a contractor would need to explain to the public the basis of that relationship and how the contract would give effect to it. A major change to an outcome-based contract would also need careful explanation.
- 4.029 Members of the public need sufficient time to absorb the implications of any change of service arrangements, both as to how they may be affected personally (e.g. service delivery levels at their own home) and how the local authority itself will be affected.

⁸ Sections 247b and 223c of the Local Government Act refer.

- 4.030 QLDC intended to hold several public meetings and made considerable detail available on its web site. The proposed TMM contract also received considerable press coverage.

Consulting the Business Sector

- 4.031 The business sector can have various expectations of the local authority. Those business people that we spoke to in Queenstown told us of their expectations that:
- a sound decision-making process is followed;
 - there is a definite ability to reduce costs through contracting out;
 - high-level management and monitoring capability exists;
 - “at the worksite” accountability is taken on by the TMM contractor, and the TMM contractor has a high level of knowledge about the location and condition of assets; and
 - there would be good communication between the various QLDC contractors (in QLDC’s case, good communication between the TMM contractor and the contractor providing regulatory approvals would be essential).
- 4.032 Good communication may require the local authority to establish protocols between its various contractors for managing any conflicts between their respective functions and obligations. Any such protocols would need to be agreed before finalising the long-term contract so that both parties are aware of any cost implications before the contract price is set.

Consulting Subcontractors

- 4.033 Subcontractors also expect the local authority to think long term. Their concerns include:
- the need for subcontract work to be available on an ongoing basis;
 - how the head contractor would handle bids for subcontracts (e.g. whether or not the head contractor had to accept the lowest bid); and

- the degree to which a subcontractor could be locked out of subcontract work after a dispute with the head contractor.

4.034 The local authority needs to be able to demonstrate:

- that it is clear about what may happen in the subcontractor market place; and
- how it intends to respond to any complaints about the operation of that market place.

4.035 QLDC and LCS intended to establish a joint tenders panel to consider subcontracts. Such a protection for subcontractors should prevent the contract substantially lessening competition in the subcontractor market.

Responsibility to the Public

Expectation

4.036 We expect the local authority to consider, define, and reflect in the contract the respective responsibilities of itself and the contractor to the public (inherent in an outcome-based contract) that put day-to-day decision making into the hands of the contractor.

Who Should Be Responsible for What?

4.037 One of QLDC's reasons for the proposed TMM contract was to transfer all operational decision making and associated risk to the contractor. In addition to the usual decisions affecting day-to-day service delivery, the contractor rather than the Council would decide, for example, when to replace pipelines.

4.038 The nature of the proposed TMM contract was such that the Council would retain the function of revenue-raising from the ratepayers and other service users, and have a quality assurance role, but would otherwise take no responsibility for service delivery.

4.039 As we said in our report *Contracting Out Local Authority Regulatory Functions*:

Contracting out under section 247D [of the Act] does not relieve the local authority (or any member or officer of the local authority) of the “liability” to perform or ensure the performance of any function or duty imposed on the local authority or person by the Act or any other Act.⁹

4.040 The local authority may also need to consider (in addition to the legal position) the ‘political’ implications of the transfer of responsibility to the contractor. The public can probably be expected to look to the contractor in the first instance for performing the expected services. But, ultimately, the public can be expected to hold the council responsible – because only the council is in a position to influence the contractor’s behaviour. And the members of the council are electorally responsible to the public.

Formulating the Contract

Expectation

4.041 We expect the local authority to:

- ensure that the contract is drawn up in such a way that it creates the type of relationship intended, and neither party can obtain some unilateral advantage;
- agree to a contract period that is consistent with its long-term goals and the realisation of the desired benefits; and
- be able to demonstrate that the contract provides the means for it to be assured that the services are being provided, and the public assets are being maintained, to the required standards.

⁹ Paragraph 207, page 22.

Equality of Benefit

- 4.042 A long-term contract should ensure that the contract starts with an equality of benefits between the parties and (as far as can be foreseen) neither party is able subsequently to obtain some unilateral advantage. Matters such as the outcomes required and the price to be paid need to be determined so that they may only be changed by mutual agreement.
- 4.043 If there is to be a change in the terms and conditions of the contract, or if there is a change in external conditions, that benefits the contractor, there needs to be a complementary benefit for the local authority. There should not be a possibility for the contractor alone to gain an advantage by varying the outcomes required, payments, or the risk allocation during the term of the contract.
- 4.044 It is important that councillors understand that “equality of benefit” needs to work both ways. The local authority will not be able to claw back additionally (and without “cost”) any “perceived loss” to it that it considers might be occurring.

What Is an Appropriate Contract Period?

- 4.045 There is, in our view, no standard or “ideal” period for a long-term contract for services. Rather, an appropriate term should be determined by reference to factors such as the life-span of physical assets covered by the contract and the level of investment required of the contractor.
- 4.046 The costs and benefits of different contract periods should be explored.
- 4.047 A contract period that is too short to provide the appropriate incentives for a contractor could lead to a higher contract price. A period that is too long could lead to circumstances such as:
- the contractor obtaining very high unanticipated profit levels for a long length of time towards the end of the contract; and
 - the contractor rather than the council obtaining the benefit of changes and advances in technology over the contract period.

- 4.048 Transit New Zealand (TNZ) has opted for a 10-year period for its “performance maintenance contracts” (PMCs). We understand that TNZ considered 15 to 20 year periods in order to encourage better ‘whole of life’ decision making. However, TNZ was concerned about who would benefit from efficiency gains over the longer periods.
- 4.049 TNZ believes that 10-year contracts, under which it continues to cover some risks, are cheaper than contracts of even longer periods. A 10-year period also exerts pressure on the contractor to perform quickly.¹⁰
- 4.050 A key risk is that the contractor does not have the incentive to continue on to the end of the contract, or to perform effectively throughout the contract period. The contract should address that risk. For example, an appropriately structured payment profile could ensure that the payments to the contractor do not provide higher returns in the early years – reducing the incentive to complete the contract period.
- 4.051 Another factor to consider in determining the length of the contract is the contractor’s capacity to continue in operation for the entire period. The contractor may have the opportunity to borrow against future cash flows to fund investment decisions (as was intended with the TMM) during the early period of the contract. Nevertheless, the local authority will need to be assured that the contractor has the financial security and backing to perform the contract obligations for the period committed to.

Quality of Service

- 4.052 Securing quality of service based on outcome measures and standards requires particular care in deciding what constitutes “quality” and how it will be reflected in appropriate measures. One such measure and standard proposed by QLDC has been mentioned in paragraph 4.009.

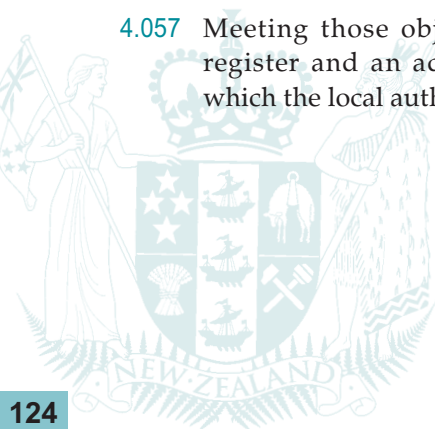
¹⁰ However, roads tend to have an economic life of 10-15 years compared with, for example, water and wastewater systems that have much longer economic lives.

- 4.053 For road signs, TNZ has created a 1-5 scale of scores for sign condition, based on physical characteristics such as visual appearance and reflectivity. An outcome-based contract with TNZ may therefore require the contractor to achieve an agreed score “on average across all signs”.
- 4.054 However, in a local authority context such a quality measure and standard might mean that a particular sign remains in a poor condition (at, say, level 1) for longer than a complainant and their councillor representative would have considered acceptable previously.
- 4.055 Another consideration is that the local authority could face increased costs if it wishes to specify quality of service measures at too detailed a level.

Quality of Assets

- 4.056 The contractor will be responsible for the local authority-owned assets that are at the heart of the contract. The local authority and the contractor need to be agreed on:
- the identity of all the assets involved;
 - the standard of physical condition of those assets at the start of the contract;
 - what standard of physical condition the assets need to be kept up to (including renewal or replacement as necessary); and
 - what standard of physical condition the assets must be in at the end of the contract (whether that is at the end of the agreed contract period or earlier as the contract provides).

- 4.057 Meeting those objectives requires both a proper asset register and an adequate asset management system to which the local authority has full and open access.



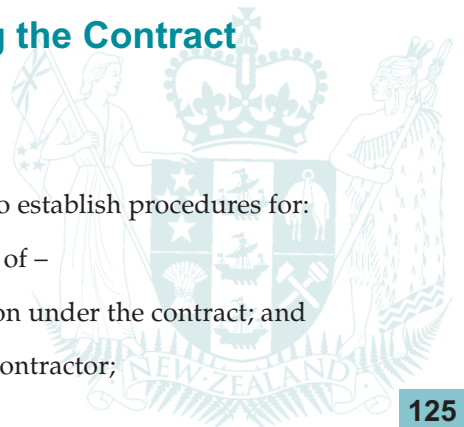
Contractor Performance

- 4.058 Contractor performance needs to be addressed in three dimensions:
- meeting the quality of service measures and standards;
 - maintaining the local authority's assets to the required standard of physical condition; and
 - satisfying public expectations of the services being provided.
- 4.059 The first two of those performance dimensions were dealt with in the preceding paragraphs.
- 4.060 The contractor needs to be able to respond to public complaints directly, and the contract would need to at least outline how a complaints procedure should work in practice. The local authority needs to monitor public satisfaction with the services provided by the contractor and the contract should recognise this need.
- 4.061 The contract also needs to provide for:
- what constitutes poor performance or non-performance on the part of the contractor, and how it is established; and
 - what remedies are available to the local authority in the event that poor performance or non-performance is established.
- 4.062 Those remedies might range from a formal warning, through monetary penalty, to termination of the contract.

Managing and Monitoring the Contract

Expectation

- 4.063 We expect the local authority to establish procedures for:
- assuring itself of the quality of –
 - day-to-day service provision under the contract; and
 - asset management by the contractor;



- assuring itself of the continuing financial viability and stability of the contractor; and
- ensuring that it obtains all the information it needs for the purposes of managing and monitoring the contract.

Quality Assurance

4.064 The basis for the local authority being assured about the quality of service delivery and asset management will be contained in the contract. The local authority needs to determine its policy on, and establish the corresponding procedures for:

- who is responsible for dealing with the information provided by the contractor;
- what is to be done when the information is not received on time or is not received at all;
- who is responsible for assessing the information received (which could be a local authority staff member, or an external expert adviser, or a combination of the two);
- what reports of the assessments (or non-receipt of the information) are to be made and to whom the reports should be sent; and
- who is responsible for taking what action on the basis of the reports.

4.065 Among the matters that the policy and procedures should address are:

- the balance between concern about day-to-day operational performance and concern for overall contract performance; and
- the frequency of contact between the local authority and the contractor about performance issues.

4.066 The local authority should consider telling the contractor about its satisfaction with the contractor's performance as well as about matters for dissatisfaction.

Contractor Viability and Stability

- 4.067 The local authority has an interest in whether the contractor:
- is in a viable financial condition to continue to perform the contract obligations; and
 - remains committed to performing those obligations.
- 4.068 The level of information that the contractor should be expected to provide about its financial position is a matter for the local authority to decide and the contractor to agree on. For example, there should be no need for the local authority to know the degree to which any particular services turn out to be more profitable for the contractor than originally envisaged. At the least, we think that the local authority should obtain regular assurance as to the contractor's financial position by being provided with audited annual financial statements.
- 4.069 There is also the possibility that the contractor may remain financially viable but might take a view of its business direction that means the contract with the local authority is no longer in its best interests. The authority needs to ensure that it has access to any information that suggests such an attitude on the part of the contractor. It could include some sort of 'notice' provision in the contract, but may also (in addition or instead) establish its own intelligence-gathering mechanism for the purpose.

Information Flows

- 4.070 The local authority has a range of requirements for information in order to manage and monitor the contract and for other related purposes – including:
- revenue raising;
 - reporting to the public;
 - monitoring contractor performance;
 - monitoring asset condition;



- taking over in the event of contractor failure; and
- potentially, changing to a new contractor at the end of the contract.

4.071 We have mentioned all but the last of those purposes in the preceding paragraphs.

4.072 At some point in the future the relationship with the contractor will end. The local authority needs sufficient information from the contractor as the contract progresses and at the end of the term to be able to adequately inform any new contractor. In the absence of sufficient information, a new contractor may add a premium to the new contract price to cover uncertainties from poor information.

Accounting Considerations

Expectation

4.073 We expect the local authority to identify the accounting implications of a long-term maintenance contract before entering into the contract. Where the contract is extremely complex, the authority should seek advice to ensure that the accounting treatment for the transactions arising from the contract is in accordance with generally accepted accounting practice.

What Kind of Implications?

4.074 The proposed TMM contract provided for QLDC to make an annuity payment to the contractor for each asset type. The amount of each payment was to cover operating costs and the projected capital expenditure over the contract period (i.e. 30 years). However, the capital assets (whenever purchased) were at all times to remain owned by QLDC.

- 4.075 So far as QLDC would be concerned, that arrangement gave rise to such questions as how it should account for:
- the difference in any year between the portion of the annuity payment to pay for capital expenditure and the actual capital expenditure by the contractor; and
 - the obligation attaching to the capital portion of future annuity payments where actual capital expenditure by the contractor exceeds the cumulative value of the capital portion of annuity payments.
- 4.076 There are no accounting standards in New Zealand that deal specifically with accounting for long-term service contracts. Such contracts are often complex agreements and accounting for the resulting transactions is unlikely to be straightforward.
- 4.077 Consequently, it is important that the appropriate manner of accounting for the transactions is determined early so that there are no surprises to the authority's shorter-term plans for revenues and expenses.
- 4.078 Determining the appropriate accounting treatment requires:
- a thorough understanding of the substance of the agreements in the contract; and
 - an ability to apply accounting concepts to the transactions arising out of the contract reflecting the substance of the agreements.

