

Managing contracts under the UK's Private Finance Initiative: evidence from the National Health Service

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English

Over recent years, a number of contributors to the public management literature have argued that the buyer–supplier relationships generated by the UK Private Finance Initiative (PFI) are qualitatively different from those generated by traditional contracting out. References have been made to equality, transparency, risk-sharing and trust. In this article, the authors test a contrary argument: that UK public managers negotiate and implement PFI contracts within an environment which is, to a significant extent, characterised by supplier opportunism, something that requires them to employ an extremely assiduous, if not necessarily distant, approach to contract and relationship management. The testing of this argument is undertaken with evidence from PFI construction contracts operated within the National Health Service.

Français

Ces dernières années, un certain nombre de collaborateurs aux publications sur la gestion publique ont soutenu que les relations acheteur-fournisseur engendrées par la UK Private Finance Initiative (PFI) sont qualitativement différentes de celles engendrées par une sous-traitance traditionnelle. On se réfère à l'égalité, la transparence, le partage du risque et la confiance. Dans cet article, les auteurs testent un argument contraire: que les gestionnaires au Royaume Uni négocient et mettent en application des contrats PFI dans un environnement qui est, dans une large part, caractérisé par l'opportunisme des fournisseurs, ce qui exige d'eux qu'ils emploient une approche au contrat et à la gestion des relations qui est extrêmement assidue, sinon nécessairement distante. Le test de cet argument s'effectue avec des preuves se rapportant aux contrats de construction PFI en cours à l'intérieur du National Health Service.

Español

En años recientes, un número de contribuyentes de la literatura de dirección pública ha discutido que las relaciones entre el comprador y el proveedor generadas por la Iniciativa Financiera Privada (PFI) son diferentes a nivel cualitativo de aquellas generadas por un contrato aparte tradicional. Se han hecho referencias a la igualdad, la transparencia, el compartir el riesgo y la confianza. En este artículo, los autores prueban un argumento contrario: que los directores públicos del Reino Unido negocian e implementan contratos PFI en un ambiente que es, en gran medida, caracterizado por el oportunismo del proveedor, algo que les requiere que empleen un enfoque extremadamente asiduo, si no necesariamente distante, al contrato y la relación de dirección. La prueba de este argumento se emprende con evidencia de contratos de construcción de la PFI operados en el Servicio de Asistencia Pública Sanitaria.

Key words: Private Finance Initiative • contract management • opportunism • National Health Service

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Introduction

In 1992, the UK government launched the Private Finance Initiative (PFI). The PFI has been an important element of the Labour government's modernisation agenda since 1997 (Newman, 2002) and has represented a further extension of the New Public Management (Pollitt and Bouckaert, 2004). Its existence, however, has always been controversial. While the UK government has claimed that the PFI provides value for money for the taxpayer, citing evidence from studies such as those undertaken by Arthur Andersen and Enterprise LSE (2000) and the National Audit Office (NAO, 2003a), others have found fault. PFI projects have been accused of incurring higher capital and transaction costs (Spackman, 2002; Froud, 2003), being tailored to private sector needs (Gaffney and Pollock, 1999), adversely affecting public sector flexibility (Pollock, 2006) and being based on a dubious assessment process, the public sector comparator (PSC), which underestimates the cost (Price and Green, 2000).

The focus of this article, however, is different and concerns the appropriate management of PFI contracts and relationships. Over the past 10 years, a number of contributors to the public management literature have argued that the buyer–supplier relationships generated by the PFI are qualitatively different from those generated by traditional contracting–out (Grimsey and Lewis, 2005). It has been suggested that the normal rules of adversarial commercial exchange have, to some extent, been replaced by rules promoting the ‘common interest’ (Sullivan and Skelcher, 2002). References have been made to relationship equality, transparency, risk-sharing and, of course, trust (Treasury Taskforce, 1997; Gerrard, 2001; van Ham and Koppenjan, 2001; Geddes, 2005; Grimsey and Lewis, 2005). As a result, public managers have been encouraged in some quarters to pursue a ‘relational’ rather than ‘adversarial’ approach to their PFI suppliers (Grimsey and Lewis, 2005).

In this article, the authors put forward, and then test, a different argument. This is that (a) UK public managers negotiate and implement contracts (including PFI contracts) within a commercial environment that is, to a significant extent, characterised by supplier opportunism (Walsh, 1995) and that (b) this requires them to employ an extremely assiduous approach to contract and relationship management (Chiles and McMackin, 1996). The argument maintains that the normal rules of adversarial commercial exchange do still apply under the PFI, in what are still essentially principal–agent exchanges (Klijn and Tiesman, 2005).

This is not to say that it follows from this argument that the management of PFI contracts should be distant; the complex nature of most PFI contracts does not allow that anyway. It is just that, according to this argument, the need to cooperate over operational matters should not obscure the fact that there will be intense competition over commercial matters. The existence of cooperation and competition within a single buyer–supplier relationship is not a contradiction. On the contrary, they are the two inherent properties of all buyer–supplier relationships (IMP Group, 2002).

All relationships contain some degree of cooperation; the simple act of agreeing to trade with another organisation, exchanging basic contractual information, is a cooperative act. On many occasions, of course, it goes much further than this, the PFI providing examples. Likewise, all relationships contain a competitive element. Even in relationships with extensive cooperation, where the surplus value is greatly

increased, there is still the need for that surplus value to be divided into producer and consumer surplus.

An extensive literature suggests that both market power (eg, monopoly, monopsony, etc) and, more controversially, opportunism (eg, information problems and hold-up) have a large impact on this division, although this does not mean that there is always acrimony between the contracting parties (Porter, 1980; Milgrom and Roberts, 1992). In this context, therefore, a key contract and relationship management skill concerns the ability to manage this duality effectively. That is, the ability to manage commercial tensions in a manner that still permits operational cooperation between the two parties.

The article is divided into three parts. First, the concept of opportunism is discussed further. Second, the relevance of this concept to PFI contract management is assessed through research into construction PFIs within the National Health Service (NHS). Third, the authors assess the broader implications of the research. The contribution of the article is threefold. First, it provides new and systematic evidence on the commercial challenges and specific governance mechanisms and practices that exist within the PFI arena. Second, it records the attitudes towards contracting held by PFI managers. Third, it assesses the managerial factors that cause a variation in the outcomes of PFI contracts. In doing so, it adds to a gradually expanding body of public contracting literature that examines the existence (or otherwise) and implications of supplier opportunism.

Supplier opportunism: behavioural foundations, economic problems and management solutions

Opportunism has been defined as self-interest-seeking with guile (Williamson, 1985). It is often presented as being in opposition to the concept of trust, defined here as the expectation that others will not fail us, even if there are perceived opportunities or incentives for defection (Nooteboom, 2002). Opportunism is now a mainstream economic concept that underpins both the hold-up concerns of transaction cost economics and the information asymmetry concerns of agency theory (Milgrom and Roberts, 1992).

While the concept of opportunism refers to specific actions taken by managers, to fully understand the issue it is necessary to distinguish between an opportunistic disposition and an opportunistic action. A disposition towards opportunism refers to the behavioural preference of a manager. Whether that person will engage in an act of opportunism, however, depends on whether they believe that behavioural preference to be feasible or desirable given the particular transactional context. The mechanisms of contingent renewal (Bowles and Gintis, 1998) and reputation (Fitzroy et al, 1998) are particularly relevant here, as is, of course, assiduous contract management. This distinction between disposition and action is important as it raises the possibility of opportunism being restrained, a key theme in this article.

In this article, three specific problems of supplier opportunism that have been associated with certain PFI contracts (see methodology section) are investigated in order to ascertain their wider relevance to PFI contract management. These problems are pre-contractual drift, leverage during negotiations over variations and quality shading. In the remainder of this section, the three problems, and the

various management practices that can be adopted in an attempt to address them, are described. The management practices include a number that are specific to each of the three problems and two that can be used with all of them. These latter two are contingent renewal and reputation.

Pre-contractual drift

The first problem concerns the tendency for the supplier to take advantage of the period between (a) being named as the preferred bidder and (b) the financial closure of the contract. The problem can often be a serious one in complex contracts as the period of time can be significant; over a year is not untypical. This length of time provides an opportunity for the supplier to invoke the practice of hold-up. Hold-up is said to have been successfully executed when A has been able to force B to accept a disadvantageous movement in the terms of the contract because of the lack of alternative solutions outside of the A–B relation available to B.

Hold-up can occur in this type of circumstance because, as time progresses, the buyer will be increasingly reluctant to reverse the procurement process and hold another competition. This reluctance causes a significant shift in the balance of power, which the supplier can choose to exploit, for example, by seeking to renegotiate its winning bid. This is not likely to be done in one single act. Rather, the supplier will usually seek to secure a number of small movements in its favour, each one never sufficient to prompt the buyer to reverse the procurement process. Each time one of the small movements is attempted by the supplier, it will invoke hold-up; it will argue that, for example, work will need to stop or functionality be reduced unless its demands are met.

There are two main practices that buyers can use in an attempt to address this form of hold-up. The first is to maintain competitive tension (two or three suppliers) for as long as possible, until all the final bidders have very well-developed proposals (PAC, 2003a). This can be expensive, but is often effective in preventing pre-contract drift as (a) there will be less time (effectively a sunk cost) between the selection of the preferred bidder and financial closure, (b) there should be fewer areas of ambiguity for the chosen supplier to exploit and (c) the buyer can more credibly threaten to reverse the procurement process and select another of the final bidders, as those bidders will have well-advanced proposals.

Linked to this is a second practice: allowing sufficient time to reverse the procurement process. A failure to allow sufficient time was a critical factor in the failure of the recent Libra IT project run by the Lord Chancellor's Department (NAO, 2003b). Here the ability of the department to reverse the procurement process was, among other things, constrained by political pressure to meet tight project deadlines. This led to the department persevering with the draft contractual agreement, even when it was being forced to surrender enormous financial territory.

The management of contractual variations

The second problem is again a problem of hold-up. Variations are defined as changes to a contractual agreement. They can be required for one of two reasons. First, a post-contractual realisation on the part of the buyer that the current agreement is

not appropriate. Second, a genuine change in the contractual circumstances. The first usually occurs because of poor specification practice; the information for a complete contract is available, but not captured. The second occurs when a contract is characterised by uncertainty: a situation where there are unimaginable future possibilities (Knight, 1921; Froud, 2003). If a contract is signed under conditions of uncertainty, it will inevitably be incomplete, something that will lead to negotiations during the contractual period as requirements become clearer. Yet, however they come about, if the post-contractual power relation favours the supplier, it will be able to invoke hold-up and make it difficult for the buyer to negotiate those variations effectively.

Three factors in particular affect post-contractual power relations. The first is relationship-specific assets (Williamson, 1985). These can often be asymmetric (Lonsdale, 2005a). The second factor concerns switching costs: the costs of search, negotiation, contracting and induction. These costs can be significant. For example, they were estimated at £44 million in the relationship for the NIRS 2 system (Lonsdale, 2005a). The third factor is time. If one party to a transaction needs certain actions within a relationship to happen urgently, it can again be vulnerable to hold-up. The Devonport nuclear contract managed by the Ministry of Defence was a classic case of this factor affecting the negotiations over post-contractual variations (NAO, 2002).

In response, there are a number of practices that can assist in the effective management of contractual variations. Practice will need to differ depending on whether the transactional circumstances are characterised by certainty, risk or uncertainty (Knight, 1921). In the case of certainty and risk, the task concerns prevention rather than cure. The aim here is to minimise the number of variations that are required by establishing a cross-functional team that can work up an extremely detailed and comprehensive input or output-based specification (Commission for Architecture and the Built Environment, 2001). This is possible under conditions of certainty and risk and any failure is simply down to poor management or inadequate resources.

Under conditions of uncertainty, however, contractual variations are inevitable (Williamson, 1985). Because of this the task is different and concerns the need for the buyer to try to ensure that it is able to undertake the resultant post-contract negotiations effectively, ie, from a position of reasonable strength. This can be done in one of two ways. First, the buyer can seek to 'balance the contract' between the two parties. This might happen naturally through both parties making significant relationship-specific investments. Where it does not, the potentially vulnerable party may seek to offset their weakness by requiring the other party to post a financial bond, one that is forfeited should the terms of the contract be violated. Such bonds are usually referred to in the literature as 'hostages' (Williamson, 1985). National Savings and Investments provided a recent case of the public sector successfully employing 'hostages' (NAO, 2003c). Second, where the nature of the project permits, the buyer can put into a contract a mechanism whereby variations can be the subject of competitive bidding. This will only be feasible, however, where it is possible to isolate a variation from an overall project. Where it is not, even benchmarking may be difficult.

Quality shading

The final problem occurs when a supplier is able to reduce the quality of the goods or service being purchased, for example, by using cheaper inputs, without violating the contract (Hart, 2003). This is possible when the contract is incomplete or contains ambiguities. By reducing costs through quality shading, the supplier is able to increase its profits. On some occasions, quality shading will eventually be detected by the buyer. If so, this takes the management of quality shading into the realm of hold-up. If the supplier has the ability to hold up the buyer, through the buyer's lack of alternatives, then, even though its opportunism is evident, the buyer may be powerless to prevent the supplier from making a financial gain. On other occasions, however, quality shading can go undetected by the buyer. For example, when a supplier uses cheap building materials it can be difficult to identify. When quality shading does go undetected it comes under the heading of moral hazard, not hold-up (Milgrom and Roberts, 1992). Moral hazard is defined as an information problem that occurs when the post-contract actions of one party are not visible to the other.

In terms of the management of quality shading, a number of options present themselves. First, where quality shading has been identified, raising the possibility of hold-up, there is the need to maintain a balanced post-contractual power relation, as discussed earlier. Second, managers can seek to dissuade suppliers from attempting acts of quality shading in the first place. On the one hand, managers can develop incentive contracts that reduce the desire on the part of suppliers to shade quality (Fitzroy et al, 1998). This can be achieved by making the payments under the contract dependent on performance, either through penalties or bonuses.

On the other hand, monitoring regimes can be established that reduce the scope for quality shading (Milgrom and Roberts, 1992). Monitoring regimes can be divided into two types. The first involves the buyer actively policing the supplier. The second involves the supplier self-monitoring, with the buyer undertaking periodic audits. Usually, buyers will employ incentives and monitoring in tandem. It goes without saying, however, that these mechanisms are not guaranteed to be effective. It is not uncommon for acts of quality shading to go either unnoticed, despite a monitoring regime, or not affect the performance indicators within an incentive contract.

Contingent renewal and reputation

The management mechanisms and practices described above are problem-specific. They can be supplemented by two further mechanisms that apply to all types of opportunism: contingent renewal (Bowles and Gintis, 1998) and reputation (Fitzroy et al, 1998). Contingent renewal refers to situations where the current behaviour of the supplier is affected, that is, improved, by the prospect of future business with the buyer, assuming it has future business to offer. Reputation can also temper supplier behaviour, although the buyer has less control over it. Some, although not all, suppliers will desist from certain acts of opportunism if they believe their long-term reputation will suffer. Unfortunately for buyers, predicting which suppliers will be governed by 'the shadow of the future' is a less than perfect science, although

efforts at the supplier selection stage can mean that it is not entirely down to chance (Watt, 2005).

Methodology

Between September 2005 and August 2006 the authors undertook qualitative research into the nature of PFI contract management within six NHS hospital trusts. The authors conducted semi-structured interviews with 17 managers and reviewed provided documentation. Fourteen of these managers were part of the trust PFI teams created to manage both the construction of the hospital buildings and the operation of the facilities management services. The 14 included three managers who headed their trusts' PFI teams and 11 others whose specialities were finance, contracts, capital development, facilities management, project management and estates.

The other three managers were from firms that advise both clients and contractors about the PFI. They had advised trusts in three of the cases and were interviewed to obtain a more 'neutral' perspective on the PFI contracting process. The picture would have been completed, of course, by interviewing the suppliers to the trusts. For understandable reasons, however, none of the trusts wanted their long-term suppliers to be questioned about opportunism. To broaden the research base, the authors also conducted background interviews with a member of the Commission for Architecture and the Built Environment, a member of the Department of Health's PFI unit, three contract managers involved with PFI contracts elsewhere in the NHS and four managers within suppliers who provide infrastructure and services to the public sector.

In order to publish the data in this article, the authors had to provide the trusts with anonymity. The trusts are referred to, therefore, as South East Trust (SET), North East Trust (NET), Greater London Trust (GLT), West Midlands Trust (WMT), Borders Trust (BT) and South Midlands Trust (SMT). The six projects were all hospital building projects, although the GLT project involved some refurbishment as well. All of the contracts were design, build, finance and operate, although the facilities management (FM) services at NET were restricted to 'hard FM', that is, FM services related to building maintenance. The value of the four projects at financial closure ranged from £24 million to just over £250 million.

To assess the existence or otherwise of supplier opportunism within the PFI environment, and the management approaches that are being adopted in response, three problems of opportunism were chosen. These were the three discussed in the previous section. They were chosen because of their appearance in publicly available reports about three other NHS PFI hospital projects: Dartford and Gravesham, Paddington Basin and Carlisle (NAO, 1999; Weaver and Long, 2001; In the Back, 2005).

Evidence on the existence and management of supplier opportunism in NHS PFI projects

The nature of business behaviour in the UK

The interviews started with an investigation of the managers' views on the nature of business behaviour in the UK. The three problems featured in this article are

not the only possible manifestations of opportunism so a broader question about behaviour was necessary. The interviews revealed that five out of the six trusts – SET, NET, WMT, BT and SMT – were managing on the basis that opportunism was a significant feature of supplier behaviour. The managers in the sixth trust – GLT – reported a different picture. They believed that their supplier was not significantly opportunistic, although their management approach was still very detailed.

The managers within WMT, NET and SMT appeared to be the most concerned. For example, the head of the PFI team at SMT said:

‘Without doubt, the private sector will try to come back for extra money for every risk they haven’t thought of before and do so by trying to pass off that risk as something new. They will use everything to increase costs, in particular any ambiguities in the trust’s requirements. It is like a game of chess and you need an experienced team who knows how to play the game in order to obtain value for money.’

The lead advisor to NET echoed this view:

‘The contractors will try to get away with everything possible, cut back where possible and the client has to try to tie them down as much as possible. These attempts will never be fully successful.’

The managers within SET and BT appeared slightly less concerned about the extent to which opportunism would feature during the contractual period, but, as shall be shown, still stressed the need to address the potential for opportunism within the contracting process.

Looking beyond the managers’ basic positions on behaviour, what was interesting about the responses was that most of the managers were not aware of the specific term ‘opportunism’ and were surprised that such a term was deemed necessary by academics. As the head of estates within SET said, opportunistic behaviour was just ‘the way things are’. This attitude was reiterated by the head of capital development at BT, who said that it was ‘the nature of business’; by the advisor to BT, who said it was ‘just business’; and by the head of the PFI team at NET, who said ‘it is part of the game’. Most of the managers seemed to expect, and ‘discounted’, a certain level of what might be called ‘ethical slack’ (something that echoes Dutta et al, 1994). It was only deemed an exceptional issue if it crossed a certain threshold. For example, the head of the PFI team at SMT said that outright lying was ‘not acceptable’.

That opportunistic behaviour is seen as a commonplace undoubtedly contributes to the ability of buyers to manage the aforementioned duality: concurrent operational cooperation and commercial tension. The head of the PFI team at SMT, for example, said that the ability to seamlessly switch between discussions about operational cooperation and commercial disagreements was an essential client skill: ‘There is no need to let [commercial tensions] spoil the relationship’.

In fact, a consistent theme arising was that firmness on commercial issues, even to the point where, on occasions, the supplier might be dismissed from meetings, is essential if the relationship between the buyer and supplier is to develop. Commercial firmness, the authors were frequently told, earns the public sector managers the

respect of the supplier. For example, the head of capital development at BT said: 'We acknowledge that they will push all the time. They acknowledge that we will try to knock them down. It is best if both sides are open about this. You get a good relationship by being tough'.

This remarkably phlegmatic attitude about supplier opportunism was joined by a quiet optimism regarding their ability to manage it. Most believed that buyers could, not always, but on many occasions, manage opportunism through the contractual process. Most argued that, should an extensive team be assembled, and should that team manage assiduously, then many of the objectives of the buying organisation could be achieved. The nature of what that assiduous management might consist, and how successful it has been, is outlined in the remainder of this evidence section.

The existence and management of pre-contractual drift

The authors' research revealed that four out of the six trusts – SET, NET, WMT and SMT – had suffered from, or successfully managed, this problem. At SET, the problem was felt quite heavily. The trust was subjected to a number of renegotiations of the preferred bidder agreement, something that caused the gap between the PFI cost and the cost of the PSC to come down from double figures to 1% by the time of financial close. The procurement manager at WMT said that his trust had also suffered a significant adverse shift in the cost of the project at the hands of this problem. It again had significantly reduced the advantage that the PFI bid had over the PSC.

The other two trusts that acknowledged this problem – NET and SMT – however, fared better in their management. According to the major projects manager at NET, the threat to the organisation in this respect was managed in three ways. First, the PFI team maintained competition between the shortlisted suppliers until the last possible moment. This allowed it to conduct effective negotiations right up until the point where draft proposals of each supplier were significantly developed. Second, the trust included an index link in the contract. Third, the trust requested a letter from the newly chosen preferred bidder, stating that it would adhere to the agreement reached at that point.

SMT also used the competition process to their advantage. Then, after the preferred bidder had been chosen, it ensured that it had sufficient time to contest the demands of the supplier. On one occasion, when there was a dispute over who was responsible for a 'new' risk, the trust sent the supplier away and told its managers that they had three weeks to consider their position. The finance director at SMT said: 'The supplier will keep coming back for more money as long as it thinks it can get further concessions from you. You have to mean "no" to close this door in their minds. It is about credibility and you need time to become credible'. The head of the PFI team added: 'You cannot avoid this pain in the time between the selection of the preferred bidder and financial closure, but it should not affect the relationship, as long as you are firm but fair'. Some of these practices utilised by NET and SMT were absent from the pre-contractual actions of SET and WMT. In particular, the estates manager from SET admitted that the competition had not been extended long enough in the pre-contractual phase. As a result, the supplier had 'clawed a lot back'.

The existence and management of leverage in the negotiations over post-contractual variations

Managers within four of the six trusts – again SET, NET, WMT and SMT – revealed that they had experienced or addressed this particular problem. The biggest problems were experienced in the PFI project at WMT. In this project, trust managers struggled to hold the line in a large number of negotiations over variations. These variations concerned medical equipment, road redesign and improvement, a patient entertainment system and a new medical assessment unit.

Problems were also experienced at SET and SMT. The contract manager at SET reported 38 variations, including changes to the provision of x-ray equipment and conversions to ‘grey space’. As was the case at WMT, the negotiations over these variations were one-sided. The contract manager’s exact words were that the settlements were ‘at the upper end of the undesirable end of the scale – at the absolute limit’. At SMT, the negotiations have also been extremely difficult. The prices that the suppliers have come back with have been extremely high and, at the time of the interviewing, the trust was in the middle of protracted negotiations over a number of construction variations.

The managers in all of these trusts had no doubts as to why the negotiations were one-sided: the suppliers were able to invoke hold-up because their trusts had no feasible, short-term alternatives. The lack of alternatives put the trusts in a weak bargaining position, which was then exploited for commercial gain. This problem of being leveraged over variations was also recognised by the managers within NET; indeed, the FM services manager commented that it was affecting the management of the hard FM services supplier. However, on the construction side, this trust had avoided the problem as it had benefited from another factor: reputation.

How reputation benefited NET can be illustrated with an example. Six months into the construction phase at NET, a need was discovered for a partial reorganisation of the hospital layout. The reason concerned a wider reorganisation of the region’s gynaecology services. This was the type of variation that had caused WMT, SET and SMT considerable problems. However, in NET’s case, the supplier was using this project as a means of accessing the UK public sector construction market. It was keen, therefore, to reach a price that satisfied both parties.

The mechanism of reputation is also assisting SMT in the management of its hard FM services supplier. This supplier is also seeking to establish itself within the UK public sector and is also interested in establishing credibility. While the head of the PFI team at SMT said that the dealings between the two parties were at an early stage, he felt able to comment: ‘Fortunately, [this supplier] wants to establish a good reputation for service delivery. It has provided us with a good team. That team has good relations with the on-ground staff and the quality is good; indeed, better than before PFI’.

Having discussed the different experiences of this problem, the authors then investigated how the trusts were managing it. Reputation aside, there were two main aspects to management practice. These reflected an understanding on the part of the managers about the nature of risk and uncertainty. While not using this particular terminology, many of the managers seemed to understand that risk allowed prevention, while uncertainty necessitated cure.

In terms of prevention, there was a consensus that the key to minimising unnecessary variations (which is a desirable goal even in the absence of opportunism; it reduces costly delays) was extensive pre-contractual planning. All of the managers, whether or not they believed it had happened effectively in their own case (in the case of WMT definitely not), stressed the need for trusts to compile large, cross-functional teams, made up of both clinical and non-clinical staff, to plan in minute detail the requirements of the trust.

For example, the major projects manager at NET recalled that his trust had created a project team that consisted of a clinical group, a non-clinical group, a facilities management group, a human resources group, a design group, a finance and risk group and an equipment group. The information provided by the groups was used to inform the contract and the teams stayed in place until the process had reached the final bidder stage. The same practice had been replicated in all of the other trusts, if not always completely successfully.

Interestingly, this practice of using large numbers of internal managers and clinicians to draw up very detailed plans is, to a large degree, in conflict with much of the prevailing thinking on buyer-supplier collaboration. This thinking recommends the development of 'general clause contracts', a form of contractual arrangement that among other things helps reduce transaction costs (Williamson, 1985; Chiles and McMackin, 1996). The contracts that were being developed here by the six trusts were anything but general. As the advisor to NET quipped: 'If you want a door with hinges, ask for a door with hinges, otherwise you will just get a door'.

In terms of cure, there was a preference on the part of all of the interviewed managers for competition and negotiation, rather than the creation of a balanced bilateral contract. The preference was for putting clauses into the contract that allowed their trust to operate a competition for the work caused by the variation. This was often accompanied by attempts to be as well informed as possible during the negotiations. For example, SMT employed technical advisors to assist with negotiations.

However, this is not a perfect mechanism as it is not always feasible to subject all variations to competition. This is because some cannot be isolated and offered to other suppliers, or can only be done so at a high level of transaction costs. Hard FM services are an example of this. In a PFI agreement, there is usually a relationship between the design and quality of the construction side of the project and the FM service arrangement. This can be difficult to separate. Much easier to separate are many of the soft FM services, like catering and cleaning. These services are largely autonomous. The difficulties in operating competitive exercises were behind some of the above-mentioned adverse experiences of SET, WMT and SMT. The result, as was seen, was reduced bargaining power.

The existence and management of quality shading

All six of the trusts recognised this problem as relevant to the management of PFI contracts. Even at GLT, the contract manager said he 'wasn't blind to the issue'. In response, all six trusts were using a combination of negotiation, monitoring and incentives. Almost all those interviewed were also in no doubt about the motivation behind quality shading. The advisor to BT said: 'Quality shading is very common

and deliberate, although it happens to different degrees. Trusts have to be on the ball'. The head of the PFI team at SMT added: 'The contractor will, of course, try to increase its profits through quality shading. It will substitute materials or products, whilst still formally meeting the specification, and it will sub-contract if it can to firms with cheaper staff'. These views were echoed by the estates manager at SET. He told the researchers: 'Quality shading is a deliberate supplier tactic to get more profit out of the contract'.

In the case of the latter manager, while the project he was managing at SET was not sufficiently advanced for this problem to have arisen yet, he was able to give a number of examples that had occurred on the FM side of previous PFI contracts he had managed. These included the slow response times that a supplier had achieved in reacting to client requests and the exploitation by a supplier of the ambiguity surrounding words like 'clean'. The manager argued that the policy of suppliers was clearly to wait to be found out and then respond. Ideally, of course, the suppliers hoped that they would not be found out at all.

Examples of quality shading at WMT and NET can also be reported. The examples given by the procurement manager at WMT related to labour costs. In the areas of materials management and catering, the supplier had agreed, *ex ante*, to provide staff of a particular quality and experience, but, *ex post*, had not done so. Again, advantage was taken of ambiguity over terms like quality. At NET, meanwhile, an advisor to the trust said that quality shading had related to simple things like paint quality, as well as more substantial matters such as soundproofing.

As was mentioned above, all of the trusts were responding to this problem with a mixture of negotiation, monitoring and incentives. The negotiations occurred when acts of quality shading were detected. As was the case with the negotiations over variations, the outcomes of these negotiations were influenced by the post-contractual power relations that existed at any particular time. Monitoring and incentive contracts, by contrast, were employed in an attempt to stop acts occurring in the first place. The importance of effective monitoring within the PFI environment was emphasised by the head of the PFI team at SMT: 'No monitoring; no value for money. [The supplier] will chip away at the deal struck. You have to investigate, you have to check, you have to be firm'.

In terms of the nature of the monitoring, two types were used. First, monitoring was undertaken by trust personnel. Examples of this come from NET and SET. At NET, the trust retained the 'shadow design team' that had been established during the pre-contractual phase. This team monitored the development of the hospital to completion. At SET, meanwhile, senior executives and the estates department were, at the time of interviewing, just about to engage the clinical and non-clinical staff in the monitoring process. The estates manager at SET recalled how he had experienced success with such an effort in a past PFI project. In that project, the senior management within the trust spent a great deal of time trying to enable the clinical and non-clinical staff to act as monitors.

Their policy consisted of two main elements. One, much time was spent educating the relevant staff as to their new responsibility. They tried to impress upon them that they should ensure that the supplier was confronted and penalised when it performed poorly. Not surprisingly, having such a responsibility is a great 'culture shock' to clinical staff. Two, the management devised a simplified version of the

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contractual metrics, particularly those relating to the penalty scheme (see below), so that the clinical staff could understand their new responsibilities. The estates manager believed that they were successful in engaging about 65% of the relevant trust staff. The second type of monitoring involved the use of independent monitors. For example, NET had an independent tester that checked that all aspects of the building were in line with the spirit and letter of the specification. The finance director at GLT, meanwhile, said that the trust used an independent tester for checking the equipment provided under the PFI contract.

The use of monitoring was accompanied by incentive contracts. The contracts in all the trusts contained a schema that linked payments and penalties to deadlines, access and service, something aimed at numerous problems, not just opportunism. This is, of course, standard PFI policy, part of what is referred to as 'risk transfer'. The suppliers to all six of the trusts did not receive their first unitary payment until the hospital was completed and had to pay penalties for downtime or poor-quality service. Clearly, in the case of the penalties attached to the levels of service provided, there is a link between assiduous monitoring and the penalty scheme.

As has been shown, in most of the trusts suppliers have made attempts to increase their profitability via acts of quality shading. These attempts have happened despite the incentive contracts that have been put in place. Suppliers have either expected not to be detected or selected acts that do not affect the performance measures in the incentive contract, or both. What is, of course, unknown is exactly how effective the monitoring regimes have been. Only the suppliers will know about those acts that have not yet been detected and are unlikely to be forthcoming.

Discussion of the findings

The evidence from the six trusts strongly suggests that supplier opportunism is a significant feature of the NHS PFI contracting environment. While the experiences of the six trusts differed, only GLT did not recognise the problem as significant. The levels of asset specificity, uncertainty and information asymmetry, while arguably not on the same scale as they are in, for example, many of the (now prohibited) PFIs for information technology and large-scale defence projects, provided a not inconsiderable scope for opportunistic acts. This was a scope that many suppliers decided to exploit.

It is important to mention that there was little evidence in the cases to suggest that this supplier opportunism was retaliatory, ie, the result of buyer opportunism. The head of contracting at WMT did report examples on a past contract he had worked on, but it was not a prominent feature of the interviews with either the buy-side managers or, more significantly, the advisors. The impression gained was that buyers wanted to limit rather than escalate opportunism, when that opportunism was within certain limits, and so simply defended against it rather than retaliated.

What seems to hinder NHS trusts in their attempts at such a defence is an inability to benefit from either the past or the future. In terms of the past, none of the trusts had any history with their PFI suppliers; they had all established new relationships. In terms of the future, the fact that NHS PFIs are managed on a trust-by-trust basis affects the ability of the NHS to benefit from the mechanism of contingent renewal. This drawback can become exaggerated if the incentives within the consortium

do not encourage the construction supplier to be concerned about the long-term performance of the contract.

However, while a reading of the evidence suggests that opportunism is a significant feature within the NHS PFI arena, it also suggests significant variation in the trusts' experience of opportunism. Three factors appear to be behind this variation. First, there was considerable evidence in the cases to suggest that there is a relationship between the tightness of management practice and both the frequency and outcome of opportunism. In terms of frequency, a buy-side reputation effect seems to develop: suppliers become more cautious in the face of a competent client. In terms of outcome, assiduous management limits supplier gain. This relationship has been reported elsewhere in the UK public sector, for example in the contract for electronic tagging (PAC, 2006), the Libra IT project and the National Savings and Investments business services outsourcing (Lonsdale, 2005b). It is certainly a causal relationship that has led to the trusts attempting to assemble the most experienced team possible, and keep it intact (a challenge as PFI experience makes managers attractive to the private sector).

This need for assiduous management practice may seem very obvious, but it actually goes to the heart of the debate over contract and relationship management. As noted earlier, many are arguing for approaches to contract and relationship management that reject the concept of opportunism and give suppliers greater commercial licence. The evidence here suggests that such a move would be unwise. Despite operating the most assiduous of approaches to contract and relationship management, involving large numbers of staff, many of the trusts are still struggling to contain their suppliers. Any loosening of contract management practice is likely to be exploited for private gain. Indeed, beneath its rhetoric on 'partnership' and 'trust', the UK government seems to be recognising this reality. Many of its recent policy refinements, for example the design development protocol, the rules on refinancing and the moving within the procurement process of the full business case, have had the effect of tightening up contracting practice.

A second factor that appeared to be causing a variation in the experiences of the trusts was reputation, although its impact was relatively marginal. There were two instances in the six cases – NET (construction) and SMT (hard FM) – where reputation appeared to be having a significant impact on the behaviour of a supplier. In both of these cases, however, the suppliers seemed to have a particular agenda: the establishment of their companies within an area of the NHS PFI market following a recent entry. Not surprisingly, therefore, they were looking to make a good impression and build credibility. There was no evidence, however, of a broader reputation effect.

An indication as to why is suggested by the managers' phlegmatic attitude to opportunism, something reported in the case evidence. As mentioned earlier, the managers seemed to accept a certain amount of 'ethical slack' in their dealings with suppliers. They saw it as 'part of the game' and, crucially, common within business. It was certainly not something that would endanger the positions of established construction industry players, even assuming that information on reputation circulates the industry in an efficient manner, which cannot be taken as read given the widespread acceptance of the concept of bounded rationality (Williamson, 1985). In any case, as two parliamentary committees have noted recently (House

of Commons Treasury Committee, 2004; Clark, 2006), even if there were risks to reputation, it is commonplace for firms to place the prospect of short-term gains ahead of such risks.

The final factor causing variation concerned supplier expectations of profitability. It was reported that the degree to which opportunism was experienced was affected by a combination of (a) the ex ante profitability expectations of the supplier and (b) the extent to which those were being met as the contract period progressed. As the head of contracts at WMT said: 'If the required profitability of the contract is starting to look uncertain, the senior management of a supplier will start to put pressure on a contract team to increase the returns'. This kind of comment has been heard before in relation to PFI. In 2003, the Chief Executive of Fujitsu Services, Richard Christou, commented: 'If, in the end, many IT suppliers suffer these sorts of things [ie, lower than expected profitability or losses] then the supply of IT contracts for government will no longer exist' (PAC, 2003b, question 13). This may also be a factor that is affected by the secondary market for PFI contracts. Concerns have been raised that many new owners of PFI contracts will wish to 'sweat' the contract for additional profit, a practice that, in particular, could lead to acts of quality shading.

Conclusion: wider lessons for public contracting practice in the UK

The evidence from the six cases considered in this article suggests that opportunism is a significant feature of the NHS PFI contracting environment and is something that requires very careful management attention. The final question to be addressed in this article concerns whether these findings from the NHS can be generalised. The authors are inclined to say that they can. While there were certain NHS-specific factors affecting the cases, there is little to suggest that the NHS is exceptional. The construction and FM suppliers in the cases serve many other parts of the UK public sector and the findings echo other studies into opportunism within the UK public contracting arena (Walsh, 1995; Parker and Hartley, 2003; Lonsdale, 2005b; Skelcher, 2005; Watt, 2005) and the 'individualist' UK economy more generally (for example, Lane and Bachmann, 1996).

However, the apparent reduced role for trust suggested here should not be a cause for despair. Operational cooperation can take place in the absence of trust (it is often simply unavoidable given the transactional properties) and opportunism can be managed. The key to understanding the latter point is the aforementioned distinction between opportunistic disposition and action. Even when managers within supply organisations have a preference for acting opportunistically, it does not mean that they will always do so. Much depends on the actions of public sector contract managers. As we have seen in the cases in this article, if managers design contracts and relationships in such a way as to mitigate the hazards described, the scope for opportunism is far more limited. Five points are particularly relevant here.

First, contracts need to be developed that are actually manageable. Part of the problem with many UK government information technology contracts, for example, is that they contain too much asset specificity, uncertainty and information asymmetry to be coped with (Lonsdale, 2005b). The UK government needs to be realistic about what can be managed contractually within an environment of

opportunism. In particular, more thought needs to be given to the practice of 'bundling' (Lacity and Willcocks, 1996), that is, the parcelling together, within one contract, of many different requirements (for example, design, construction and facilities management PFI contracts in the NHS).

Second, there needs to be greater emphasis in the procurement process on 'strategic fit'. Different suppliers will value a contract to different degrees and this will influence their propensity to act opportunistically. The two cases in the article related to reputation were examples of this. Furthermore, some suppliers will actually desist from opportunism altogether; no one claims that opportunism is universal. Yet despite the fact that 'strategic fit' is a standard consideration in supplier selection models (Cox et al, 2003), and although managers will not always make correct judgements when considering it, the public procurement rules and public managers still do not sufficiently take it into account (Watt, 2005).

Third, the UK government needs to continue with its policy of trying to benefit (in terms of reduced transaction costs and opportunism) from contingent renewal, without it becoming a cosy arrangement for a clique of suppliers. Procure21 (in the NHS) and Building for the Future (in the education sector) are examples of this policy. Fourth, the UK government needs to do more to improve the quality of contract, project and procurement managers within the UK public sector. While the PFI teams in the six cases here appeared to be quite strong, overall the skill base is patchy, something that the UK government itself has admitted (Lonsdale, 2005b). Finally, and perhaps most importantly, even when good buying teams are managing in apparently propitious circumstances, and especially when they are not, contract management needs to be assiduous. The possibility of opportunism is always a real one and not always fully predictable. Given that many procurement and contracting decisions are close to being irreversible, caution is always advised.

These five points do not only constitute a set of management recommendations; they also form the basis of an important future strand of PFI research. More evidence is needed on the relationship between these aspects of contract and relationship management and value for money outcomes, not least because of the voices calling for a contrary approach. In particular, it will be interesting to observe the outcomes of the UK government's recent attempts to benefit from contingent renewal, for example, the aforementioned Procure21 and Building for the Future. Will these initiatives reduce the frequency and magnitude of the opportunistic actions of suppliers or will the need for assiduous contracting and monitoring remain largely unchanged?

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