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FIGHTING PRIVATIZATION AND CONTRACTING OUT

HOW TO ANALYZE A CONTRACTING-OUT PROPOSAL

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How to Analyze a Contracting-Out Proposal

If your employer is proposing to contract out the operations, maintenance and management (OM&M) of a service, there are a number of ways to fight it. Whether we use our collective agreement or a public campaign, it is important to demand and obtain as much information as possible about the contracting-out plan. This includes information about any anticipated costs and savings and any potential impact on levels and quality of service.

It is important to expose the false savings and hidden costs that employers are unable or unwilling to see. When employers become too fixated on costs they are often willing to sacrifice the quality of service and accountability to the public. Therefore, costs and savings must be analyzed in the context of how services will be affected. Using this information with politicians, employers and the public can help in fighting back against the threat of contracting-out.

The examination of a contracting-out proposal or bid can be approached by asking critical questions about the impact on quality of service, public accountability and costs. Requests for proposals (RFPs) from employers or bids by the private sector can be analyzed to show the problems with contracting-out. Also, what they don't say is as important as what they specify. Employers and the private sector will often omit important information.

Quality and Accountability

Service quality and public accountability are two of the most useful issues on which to challenge contracting-out. Demanding answers to the following questions will help expose the service quality and accountability problems associated with contracting-out.

- **Would the contractor be required to meet specified quality standards, and would they be enforced?**

  The proposal should set clear service standards that the contractor must meet. Too often, the service standards and quality of service is not specified in a proposal. Cutting corners on supplies and services are one of the primary ways that contractors increase their profit margin. These, in turn, can have other negative impacts.

In order to monitor service standards, ongoing workplace evaluation of contractor is necessary. Even if the proposal or bid specifies quality standards, contractors may not meet them and public-sector managers may not measure or enforce them. If the monitoring provisions are inadequate, the contractor can get away with shoddy work. This has a direct impact on the quality of service. Finally, if the proposal or bid does not specify penalties for not meeting quality and service standards, it is much more likely that quality will suffer.

- **Would the contractor be free to change staffing levels?**

  If the contractor can change staffing levels, it may attempt to increase profits by reducing the number of employees to the bare minimum. This would have an obvious impact on quality as fewer workers are asked to do more work. Such situations, along with lower wages and benefits, produce high staff turnover which also affects the quality of the service.

- **Are health and safety issues addressed in the contract?**

  Are there circumstances in which WHMIS, first aid, or other necessary employee certification is not being required of the contractor? Contractors should comply with the same health and safety standards expected for in-house employees. For example, a private cleaning company leaving tasks undone or using toxic cleaners directly affects the health and safety of workers and the public.

- **Are the contractor's employees qualified to do the work?**

  In-house staff often have valuable training and experience that contract employees cannot match. Contracted staff usually receive lower pay and benefits, experience higher turnover, and have less training than in-house staff. For example, contractors specializing in servicing the hotel industry may require a vastly different set of skills, training and standards than people working in public institutions such as schools and hospitals.

  Poorly trained and unqualified contract employees can affect service quality and increase health and safety risks. These in turn can increase the costs of providing the service.

- **Might contracting-out disrupt services?**

  In-house staff know their workplace and when the work should be scheduled. They also have established work relationships with other staff, which helps in organizing the larger workforce so that it causes the least disruption. Contractors' lack of familiarity with the workplace and poorer communication with staff can add time and cost to the contract and may disrupt services.

  Also, even the largest contractors are vulnerable to business failure. Does the contracting-out proposal address the costs and disruption associated with such a possibility? Contractors also have been known to walk away from contracts that they cannot fulfill or that they find unprofitable.

- **Does the proposal account for all tasks currently done in-house?**

  One common feature of contracting-out is that contractors fail to cover the entire scope of work normally performed by in-house staff. Remaining in-house staff are left to do the extra tasks without additional staffing or resources. If a list of specific services and duties are not explicitly noted in the contract proposal, it is a problem. If management has not indicated how these services will be provided, this may raise questions about quality and safety. If the contractor is not providing them, does it mean that work will be passed on to in-house staff without budgeting for it; or will it be contracted-out to another provider; or will it be eliminated altogether? Such services and tasks may be essential to maintaining quality of service.

  In-house staff also often provide work that is not listed as their main duties, but yet are important. For example, an in-house school custodian could be asked by the employer to perform odd tasks such as raising a flag in front of the school or shovelling snow, whereas a contracted employee will only usually do what they have been contracted to do.

  If a public employer wants workforce flexibility that helps maintain high quality services, they should keep services in-house.

- **Would contracting-out compromise confidentiality including privacy of clients?**

  Contractors may work with confidential information, Keeping the information confidential is sometimes of utmost importance. This is especially so when contractors are directly involved with computer and information systems. The risk to confidentiality, including client privacy and the possibility that a contractor will use the information for private gain, must be taken into account when an employer considers contracting-out.

- **Would contracting-out limit management's ability to innovate or lock the public sector into inadequate service provision?**

  If public sector management wants to change certain aspects of a contracted-out service, they may not be able to do so. At the very least, the public sector would have to pay extra monies to the contractor. Alternatively, management would have to carry out the change with in-house staff, something for which it has not budgeted. For example, if management identifies a better way to distribute supplies, but the contract states that the supplier delivers at set intervals, the contractor has no legal obligation to change the schedule and can demand higher fees to make changes.

  Contracting-out proponents say contractors allow for flexibility because they can simply negotiate "change orders", to alter what was agreed to in the purchase order. What they usually fail to say is that change orders are costly and increase the bill paid to the contractors. Contractors are usually very adept at taking advantage of management's request for changes in service. Management usually either must forget about making the change or pay for the service changes.

  The contract restricts accountability to the public if management cannot respond to new needs or avoid unacceptable practices by the contractor. For example, if a nursing home is locked into a three-year contract to buy meals from a private company despite mounting complaints about the quality of food, and if there is no recourse to rectify this provided for in the proposed contract, the nursing home and the residents lose.

  Even if the public sector is allowed to terminate the contract under such conditions, it is sometimes not possible to do so. For example, if a facility contracts-out food services and closes its kitchen and the contractor's service proves unsatisfactory, the facility is in a bind because re-installing a kitchen and all of the equipment would be extremely costly.

Another aspect of this is whether the contract obligates the contractor to respond to immediate or emergency needs of the facility or institution. For example, if lab equipment in a hospital breaks down during a busy period, management may not be able to force the contractor to respond quickly. Interruptions in lab testing can have serious consequences such as delayed surgeries. However, if the equipment is serviced in-house, management can make the work a priority and respond more quickly to an emergency.

- **Would management become dependent on external contractors?**

  Contracting-out usually results in a loss of expertise within the workplace as experienced in-house staff are replaced by contractors. Once staff have left, the public sector becomes more dependent on outside expertise. This compromises the public employer's capacity to develop services, coordinate between departments and sites, and generally do innovative planning.

  Public sector institutions become especially dependent on private sector contractors if they sell off important equipment as part of the contracting-out deal. For example, if a municipality sells off its garbage trucks to a contractor, they are unlikely to be able to quickly replace them. This gives contractors more leverage with the municipality.

The full costs of contracting-out

Many expenses associated with contracting-out are never acknowledged. The actual payments made to the contractor are only part of costs, others are indirect or hidden costs. The savings promised by the contractors are always exaggerated or non-existent.

Direct costs of contracting-out

The direct cost of contracting-out are found in the contract fee. However, the contract rarely provides a full breakdown of the fee; instead, it may specify some of the components. The following list presents the range of direct costs that usually fall under a contractor's fee:

- **Wages and Benefits of Workers:** The contractor may be self-employed but is usually a larger company with many staff. If specified, the fee for contract wages and benefits far exceeds what is actually paid to the contractor's employees.

- **Salaries of Private Sector Managers:** These are usually higher than public sector managers.

- **Supplies:** Often, contractors provide supplies as well as services; supplies are often provided at inflated prices.

- **Capital equipment:** Contractors sometimes supply capital equipment at very inflated prices. Public employers, on the other hand, often receive full or partial equipment-purchase grants if they buy their own equipment.

- **Overhead:** Overhead could include the cost of an office for the contractor and associated expenses (utilities, maintenance, and support services) as well as administrative costs such as payroll and record keeping. Often, overhead expenses are at least partially provided by the public sector and are therefore a subsidization of the private contractor.

- **Insurance:** There are three common types of insurance for contractors: liability, bid bonds, and performance bonds. The contractor is usually expected to provide liability insurance to cover the cost of damages to physical structures, equipment, contractor's employees and third parties (clients, visitors, staff or others who are injured because of faulty work). Is the liability insurance set high enough? Bid bonds and performance bonds are incentives to make the contractor fulfill its responsibilities, and both are associated with larger contracts. Are the bonds set high enough to encourage the contractor to meet the service requirement demanded by the contract?

- **Profits:** The profit rate for many contractors is substantial and it is a cost. It is not usually specified in a contracting-out proposal, and can therefore, be considered a hidden cost. Now, let's turn to the hidden costs of contracting-out.

THE HIDDEN COSTS OF CONTRACTING-OUT

In addition to what the contractor directly charges the public sector, there are a whole range of indirect costs of contracting-out. These can include the cost of monitoring the contractor's performance, the cost of administration and paperwork, of cleaning up or repairing shoddy work, and of the tendering process itself. Also common are cost add-ons, particularly if the contractor makes a low-ball bid, takes advantage of a monopoly position or includes price mark-ups in the contract.

At the proposal stage and before a contract is even drafted, employers should be pressed to account for all possible contracting-out costs, including hidden costs which fall onto the public system. Asking and demanding answers to the following questions will help identify the full costs of privatization.

- **What are the legal and administrative costs to the public sector for tendering and negotiating the contract?**

  Such costs can be substantial for large projects that are contracted using a tendering process. Smaller projects are also usually tendered in the hope of soliciting lowest bids and avoiding the perception of corruption. Even if a contract doesn't follow complex procedures, managers still spend time communicating and negotiating with contractors, and that time should be added to the cost of contracting-out. Also, if there are many components to the project, and each involves a separate contractor, costs will be higher. The following activities entail costs to the employer in tendering process:

  - Preliminary discussion and planning among management about contracting-out,
  - Establishing a tendering or bid committee to set tendering rules and oversee the process
  - Development of specifications and tendering documents.
  - Advertising the tender and soliciting bids.
  - Discussion and orientation sessions with the contractors.
  - Reviewing bids/proposals and deciding which contractor wins the bid.
  - Negotiating contract terms and drawing up contract documents.

- **What are the ongoing costs of overseeing the contract?**

  This is the cost to the facility of administering the contract and monitoring the contractor's work. If the monitoring is inadequate, the job may not be done properly and the contractor may have to be called in again (adding costs). Alternatively, in-house staff may have to fix the problems (also adding costs). Administering and monitoring the contractor includes time required in:

- handling invoices and payments and bookkeeping
- auditing of the contractor's books
- scheduling worksite visits that involves both contract staff and in-house staff
- renegotiating contract pricing or other changes especially if it requires the expertise of an accountant and legal advice
- inspecting the contractor's work, and
- requesting changes from the contractor

- **Would the contractor have a monopoly, and how would that affect costs?**

  If the contractor secures a long-term contract or is the only one in the area providing a particular service, it can demand higher prices. If the facility actually sells its equipment, closes units, or eliminates specialized positions, it becomes even more dependent on the private contractors and would have to pay large sums to regain in-house capacity

- **Does the contractor's bid look like a low-ball bid?**

  These are bids that are artificially low. They come from large corporations that can afford to make them. The corporation may barely cover its basic costs or even take an initial loss. By doing so, they are hoping to "get a foot in the door" and be in a position to increase the price once established as the preferred contractor. Or they may have their eye on other services the public sector provides.

- **What is the pricing method, and what risks are there of escalating costs?**

  There are many different methods for setting the price of a contract, and each can be used by the contractor to make additional profits. If the price is fixed, the contractor may cut corners on service or use lower-quality materials or take fewer safety precautions. Otherwise, the contractor may inflate costs to increase their profits. Some contracts use a combination of pricing methods (see the definition at the end of this document).

- **Are there public sector overhead costs that would continue to apply even if the service is contracted out?**

  Overhead includes the cost of buildings and utilities such as heating, lighting, water, and ventilation. If contracting-out reduces the space needed by the public sector – for example, for food preparation or stores – but the facility does not sell off part of its property or use that space for another purpose, overhead costs continue to apply. Proponents of contracting out sometimes argue that some overhead costs are eliminated and are a saving to the public sector even when they are not.

- **Are all capital equipment costs built into the contract?**

  Contractors also may use some of the in-house equipment without paying for it. The contractor saves money while the public sector spends more on depreciation costs or does not have the equipment available for use in other areas. The public sector also sometimes sells its equipment to contractors at a price below market value. This represents a loss to the public system and should be added as a cost of contracting-out.

  Another hidden capital expense is incurred when the public sector has underutilized capital as a result of the contract. For example, if the contractor does the work off-site but the facility keeps the equipment and doesn't put it to another use. In this instance, the facility ends up paying twice: first to the contractor and second, in depreciation costs and interest payments for idle in-house equipment.

- **Are all supply costs built into the contract?**

  Sometimes contractors will use in-house supplies (for example cleaning material) even when they are expected to use their own supplies and include them in the contract fees.

- **Has the employer factored in the usual costs of fixing problems with contractor's work?**

  This is work done by in-house employees to compensate for inadequate or incomplete work done by the contractor. This often requires overtime and should be tracked.

- **Who is responsible for insurance?**

  Even where the contractor holds liability insurance, often the public sector ends up paying for either supplementary insurance or for damages not covered by the contractor. There are three scenarios, and each entails costs for the public sector.

  - If the public sector is responsible for liability insurance, the contractor may take more risks such as cutting corners on materials or procedures. If accidents result, the public sector could be liable for legal costs and higher insurance premiums.

  - If a contractor does have insurance, it may only cover physical damages or injuries to their own workers, without any third party liability. Any injuries to in-house staff or clients would then be borne by the public sector.

  - Finally, even if the contractor has comprehensive insurance, that cost will often be higher than the public employer's and the cost will ultimately be passed on in higher fees charged by the contractor.

- **What are the GST costs to the facility?**

  Some public employers lose some of their tax exempt status when they engage in contracting-out. They do not pay GST on wages for in-house staff, but they do have to pay GST on contractors' wage costs, which are considered "purchased goods". In the case of some long-term contracts, private sector contractors are applying for public sector status so that they obtain the GST rebate on purchased goods and services. This will lower the costs to the contractor.

  How much GST the public and private sectors have to pay and who gets the rebate is something that needs to be considered.

Conclusion

Asking the above questions and demanding answers to them are a means of getting at the true costs involved in a contracting-out situation. An emphasis on maintaining high service quality and accountability to the public is key. Demonstrating the various hidden costs in a contract also will help build the case that contracting-out is a bad deal for the public and should not be pursued.

Definitions: Contract Pricing Methods

Cost-plus contract:

When you take your car to the mechanic and say 'fix it' without setting any prices, you are basically saying 'cost plus'. Likewise, the contractor to the public sector is paid costs plus a profit margin. The profit margin may be either a pre-set amount or a percentage of costs. These types of contracts are usually used when it is difficult to either define the work to be done or to measure performance.

Fixed price contract:

In this type of contract, the price is fixed and applies no matter how much time or resources are ultimately needed. This, at first glance, appears to be the most favourable method for the public sector since they pay the agreed-upon price and no more. However, the temptation for the contractor is to reduce input and quality to keep their costs down and profits up.

Incentive contract:

These are somewhere between 'cost-plus' and 'fixed price' contracts. A budget is agreed to, and if there are any additional costs or savings, these are shared between the facility and the contractor. So, for example, if the price for operating a waste water facility is set at $5 million and it actually costs $4 million, then the contractor and facility will share the $1 million savings. If, on the other hand, the costs rise to $6 million, now the contractor and facility will share the $1 million loss. Savings and losses are not necessarily shared equally. There is much incentive for the contractor to cut costs even at the expense of service quality. This method also requires management to spend a great deal of time monitoring the contractor.

Incentives for contractors:

Performance bonuses are a form of incentive to the contractor to provide the required service. They are usually added onto a fixed price contract. If public sector management determines that the contract requirements were fulfilled, then the contractor receives a bonus.

Escalator clause:

The contract may have an "escalator clause" stating that when a contractor's costs increase, the contractor can charge higher fees.

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