

INNOVATIVE ASSET MANAGEMENT

Full Paper

EXTERNALISATION AS A SOURCE OF INNOVATIVE ASSET MANAGEMENT : THE CASE OF THE TRANSFER OF THE UK DEPARTMENT OF SOCIAL SECURITY ESTATE TO THE PRIVATE SECTOR

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ABSTRACT

During the last ten years, there has been a growing tendency towards externalisation (outsourcing). This situation results from technological developments, fierce competition, changing market conditions and the need to focus on core business. This trend affects companies from the private and the public sectors. In Europe, several public administrations have decided to outsource the management of all or parts of their estates. But none have been so far as the UK Government departments.

In April 1998, the UK Department of Social Security (DSS) signed an agreement to transfer the ownership and management of almost all its estates to a private consortium. The aim of this paper will be twofold :

- The first is to explain the contractual arrangements at work between the consortium and the Department.
- The second is to examine weather this transfer leads to innovative asset management and to the delivery of better services to the clients.

We will investigate these questions through the lenses of transaction cost economics. The choice of the case study results from the unusual features of this project : its size (1.64 million square metres have been transferred), its innovative asset management scheme and the role of the service in this transfer.

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I. INTRODUCTION

During the last ten years, there has been a growing tendency towards externalisation (outsourcing). This situation results from technological developments, fierce competition, changing market conditions and the need to focus on core business.

Technological changes and the introduction of new information technologies transform relationships between clients and suppliers. Intensified competition places increasing pressure on organisations to reduce total operating costs and to focus on their core business. Moreover externalisation favours flexibility and facilitates both efficiency and cost-effectiveness. Outsourcing decisions often appear to be based on the idea that market forces can lead to an improvement in service quality innovation, a reduction of costs and a creation of economic value within the supply chain.

Conversely excessive outsourcing is also presented as a way to loose its learning capacity and its competitive advantage (Foss, 1996).

Outsourcing is not limited to repetitive tasks. Even activities such as R&D which have been considered as strategic, have been partially outsourced (Quinn, 2000; Ulset, 1996). This trend affects companies from the private and the public sectors.

According to Barrett, outsourcing (or externalisation) refers to "*one type of contracting-out; namely, the process by which a user employs a separate company (the supplier), under a contract, to perform a function, which had previously been carried out in-house; and transfers to that supplier assets, including people and management responsibility*" (Barrett, 1995, p.124).

In Europe, several public administrations have decided to outsource the management of all or parts of their estates. But none have been so far as the UK Government departments.

In April 1998, the UK Department of Social Security (DSS)¹ signed an agreement to transfer the ownership and management of almost all its estates to a private consortium. This transfer known as the PRIME project², is the largest property transaction ever conducted by a UK Government department. Its net present value was £2.008 billion (using the government's real discount rate of six per cent).

The strategy literature has paid a great deal of attention to the factors that lead organisations to outsource part of their functions. Transaction costs economics and the agency theory have emerged as the main theoretical frameworks to explain outsourcing decision and contractual agreements. However the theoretical approaches slightly differ. The transaction cost theory is concerned

¹ The Department of Social Security is now known as the Department for Work and Pensions (DWP). In 2003, the contract between the DWP and the consortium was expanded to include properties from the former Employment Service estate. Now the former DSS and ES estates are run as one, under a single contract expiring in 2018. In this paper, we will only refer to the first contract and to the DSS instead of the actual DWP.

² PRIME stands for Private sector Resource Initiative for the Management of the Estate.

"with organisational boundaries, whereas in agency theorising the contract between cooperating parties, regardless of boundary, is highlighted" (Eisenhardt, 1989, p.64). Because boundary choices are predominant in the decision of the British Department of Social Security estate to transfer most of its estate to a private consortium, we will use the transaction cost framework. Our aim will be twofold :

- The first is to explain the contractual arrangements at work between the consortium and the Department.
- The second is to examine whether this transfer leads to innovative asset management and to the delivery of better services to the clients.

The full paper is organised as follows. Section 2 presents the transactions costs economics. Sections 3 describes the case study. In Section 4, we propose a theoretical interpretation of the transfer of the estate to the private consortium through the lenses of transaction costs economics. Finally, we examine whether the contractual agreements between all partners improved the quality of the service.

2. OUTSOURCING IN TRANSACTION COST ECONOMICS

The transaction cost economics provide a framework to compare alternative modes of governance : markets, hierarchies and hybrids. "*What matters is not the absolute amount of transaction costs, but the relative ranking of transaction costs associated with different organisational or contractual choices*" (Wang, 2003, p.4).

According to Williamson (1991), two behavioural assumptions and four attributes of transactions are especially important for understanding economic organisation and relationships between economic agents.

The four principal dimensions of transactions are asset specificity, uncertainty, the frequency of transactions and the ease of measurement. "*Of these four, asset specificity – which has reference to the ease with which an asset can be redeployed to alternative uses and by alternative users without loss of production value – has had the greatest significance for examining the governance of contractual relations*" (Williamson, p.79-80, 1991).

These characteristics of transactions become significant because of the behavioural assumptions : bounded rationality and opportunism.

Bounded rationality suggests that the human agents experience limits in formulating and solving complex problems. This will lead them to write incomplete contracts.

Opportunism is usually associated with the actions of economic agents which disclose information in a selective and distorted manner. This entails information asymmetries and organisational problems. These asymmetries are very strong for new services (Djellal and Gallouj, 2000).

Different combinations of asset specificity, frequency, uncertainty and measurement problems will determine which governance structure is best adapted to manage transaction :

- The market is the appropriate mode of coordination for non specific assets and occasional transaction. All the contingencies that might affect the contract are foreseen by the agents. Consequently, the client and the supplier are able to write a clear and enforceable contract. The uncertainty is limited and it is easy to implement and monitor tasks. However, the market principle may fail because participants often adopt short-term oriented strategy and for each transaction it is necessary to learn about the other (Imai and Itami, 1984). In this case, outsourcing, characterised by classical and complete contracts, is appropriate.
- When transactions are recurrent and involve specific assets, outsourcing is not appropriate. Because of the specificity, the contracts are incomplete, complex and difficult to monitor. Consequently, the hierarchy is chosen.

For example, by outsourcing some specific activities over a long period to a supplier, a client may have made himself dependant upon its supplier. Conversely, the supplier may have invested in a specific equipment. This creates a bilateral dependency. In such a situation, vertical integration is best adapted to avoid opportunistic behaviours. This strategy also reduces procurement and negotiations costs.

Conversely, the hierarchy might reduce the flexibility of the enterprise and decrease the performance level. Indeed, according to the agency theory (Jensen and Meckling, 1976), when an internal contract is established between a principal (for example the manager of the housing company) and an agent (for example a maintenance company), it is necessary to find an incentive system to avoid shirking behaviour (from the agent) and a loss of productivity.

Moreover, the internal organisation of supporting activities might lead to the development of routines and to the limitation of operational efficiencies.

The hybrid forms (between markets and hierarchies) are better suited when asset specificity is intermediary, transaction neither recurrent nor occasional. Williamson considers that this form of coordination is unstable and temporary. As soon as uncertainty increases and/or assets become more specific, hybrid forms entail transaction costs and vertical integration becomes more advantageous. The hybrid forms cover a wide range of organisational forms. Outsourcing and strategic alliances are some of them.

Outsourcing with neo-classical contracts characterised by long-term arrangement can be adapted even when high asset specificity dominate. Uncertainty and measurement problems just need to be low.

Notwithstanding the interest of this approach to provide an analytical scheme for the study of externalisation, several limits remain :

- First, according to this theory, arm's length agreements are costly. First agents are engaged in negotiations to define the terms of the contract. Once the agreement is signed, they will undertake inspection to make sure that their partner is not shirking (ex post opportunism). Given these assumptions on opportunistic behaviours, transaction costs should reach prohibitive levels when new and complex contracts are involved. However, this is not the case. In fact negotiations which lead up to a

bargain could be considered as an investment instead of a cost (Everaere, 1993). Agents rely on this process to learn about their mutual needs and to make decision to avoid bottlenecks during the implementation of the project.

- Secondly, the theory considers that there is a perfect substitutability between external and internal activities. But when a resource is integrated to an enterprise, it becomes more and more specific. "*There cannot be substitutability because a resource entering into the firm acquires new qualities and changes its nature*" (Foray, 1991, p.395).
- Finally, the transactional approach puts too much emphasis on opportunism. However, "*an organisation should be understood at least as much as a mechanism to enhance co-operation than as a device to reduce cheating and shirking*" (Menard, 1992). By and large recurrent transactions lead partners to gradually trust one another. These collaborative relationships entail learning (Lundvall, 1993).

3. THE CASE STUDY

3.1 PFI AND THE TRANSFER OF THE UK DEPARTMENT OF SOCIAL SECURITY ESTATE

The transfer of the UK DSS estate to a private consortium (the PRIME project) is part of the "Private Finance Initiative" (PFI) launched in 1992. By November 2003, 617 projects had been signed under the PFI with a capital value of over £56 billion.³

"The PFI extends the role of the private sector in the provision of what are generally considered to be public services (such as health, education, transport infrastructure, prisons and the administration of the function of the state) by signing contracts with private sector partners to design, finance, build and manage assets and to deliver associated services" (Froud, 2002).

The DSS estate was the largest civil estate in UK Government. 700 buildings covering a total floor area of 1.64 million square metres were transferred to the consortium.⁴

3.2. KEY FUTURES OF THE CONTRACTUAL AGREEMENTS

The consortium acquired the ownership of the freehold properties (37 per cent of the estate) and responsibility for rental costs on leased buildings (both

³ This figure was doubled in 2002 and 2003 by the signing of contracts totalling £28 billion for the London Underground (IFS, 2003).

⁴ In 2001, a similar contract (the STEPS Deal) was signed between another consortium and several Departments (the Inland Revenue, HM Customs and Excise and the Valuation Office Agency). 698 buildings covering a total floor area of 1.44 million square metres were transferred to the consortium (NAO, 2004).

historic and modern leases). It also supported the cost of upgrading the buildings (NAO, 1999).

During the 20 years of the contract, the Department retains rights to occupy the estate. But on expiry of the contract, the estate will remain in the ownership of the consortium. During that period, the DSS may also vacate up to 35 per cent of the estate without charge. 10 per cent of the estate was declared surplus at the start of the contract (164,000 square metres). Because the level of vacant space was expected to increase, the department negotiated rights to vacate 2 per cent a year of space agreed to be flexible during each of the first 15 years of the contract (this "flexible" part concerns 25 per cent of the estate).

The Department also transferred its existing contracts for the 13 facilities management services to the consortium. Consequently, the Department will deal exclusively with one contract rather than 160 service contracts during the 20 years of the PRIME project.

To provide services to the users of the buildings that were transferred, the consortium subcontracts building maintenance, catering, cleaning, security, energy and utilities management, equipment and landscape maintenance and waste management. The contracts between the consortium and its subcontractors were initially signed for five years. In 2003, all of them have been extended till 2018.

3.3. THE INNOVATIVE ASPECTS OF THE PRIME PROJECT

The PRIME project was very innovative from several perspectives :

- It was the first transfer of a Government department estate ever realised.
- The size of the project increased the complexity of the deal.
- The consortium members were at the origin a property investment fund, property investment specialists and facilities management companies. They almost started from scratch. They never worked together before PRIME and all of them were pursuing different strategic objectives. However this potential risk was mitigated by the competences and the financial reliability of the consortium members (the leading property investment fund was managed by the US investment bank Goldman Sachs).
- The consortium established several innovative arrangements with its service providers.
- The flexibility introduced for the estate management was also very innovative. The contract agreement allows the DSS to vacate without charge up to 35 per cent of the estate over the life of the contract. However the DSS had to pay additional costs when the deal was implemented, to compensate for the transfer of risk toward the consortium.

4. PRIME THROUGH THE LENSES OF TRANSACTION COSTS ECONOMICS

Based on the theoretical framework presented in section 2, we will examine the transfer of the DSS estate to the private sector. We will look at uncertainty, asset specificity and measurement problems

4.1. UNCERTAINTY

Innovation usually leads to an increase of risks and uncertainty. Despite the aforementioned innovative characteristics of the contractual agreement, the uncertainty of the project could be considered as medium.

Indeed several ex-ante and ex-post transaction elements contribute to reduce the uncertainty :

- The estimated project procurement costs increased between the start of procurement work in 1996 and the implementation of the deal in April 1998. During that period, consultants, financial advisers, local property lawyers and agents helped the DSS to finalise the contract. Total costs reached £10.68 million. This was mainly due to the inability to predict the workload of external advice. But this increase of project procurement costs could also be considered as an investment. It helps the DSS and the consortium to get reliable information on the estate and to limit contractual incompleteness. Consequently, it reduces uncertainty and potential ex post contractual problems.
- The five month period that followed the selection of the preferred bidder were dedicated to negotiations between the consortium and the DSS. Lots of estate data were not assembled in advance. Consequently, it was necessary to spend time and money to remeasure the buildings and to evaluate the assets. After the remeasurement, the estate was found slightly larger than the DSS previously thought. This operation led to an increase of £ 44 million of the price of the deal but it also reduces potential disturbances during the life of the contract.
- The 13 facilities management services that were transferred to the consortium were not considered as sensitive functions. Catering, cleaning, security, landscape maintenance and waste management are mainly repetitive tasks that are among the most frequently outsourced services (SESSI, 2001). All of them can be considered as non-core business functions for the DSS. So uncertainty was relatively limited. Before PRIME, most of them were already provided by several private sector contractors. But contract duration was never more than three years. Conversely some activities such as IT hardware, software or infrastructure, telephony, switchboard, that are subject to technological evolutions, were not provided by the contract.
- Uncertainty can also be reduced through information disclosure. "*Because of the limited role of the price mechanism and of the uncertainties surrounding the appropriation of rent, information disclosure will be essential to the existence and stability of hybrid forms*" (Menard, p.159, 1996). In the case of PRIME, the DSS and the consortium agreed to

introduce information disclosure in the contract to preserve the stability of the agreement. Information disclosure will allow them to share the benefits of improved operations of the estate. For example in the case of maintenance, the DSS will "*receive one quarter of savings from the deferral of avoidance of maintenance over a three year period*" (NAO, 1999, p.18). But to keep some incentives, they will not share in higher than planned costs. The sharing arrangements also concern the development of properties, utility cost savings, changes in contractor's service methods...

In the first three years of the contract, 3% of the energy costs have been saved through investment and management.

However, despite the pre-operating investments, the contract was not completely secured. The start of the contract revealed that some risks were underestimated by both partners. For example, the consortium had to pay extra costs to provide buildings with security. Conversely, the DSS believed that they transferred the landlord service charges for leasehold to the consortium. But the risk was kept by the DSS.

4.2. ASSET SPECIFICITY

The transferred estate was classified into three parts : Freehold properties (37%), historic leases (14%) and modern leases (49%). It consisted mainly of traditional office buildings located in or close to the centre of British cities. So it seems that physical assets, and particularly the freehold properties that were acquired by the consortium, could be easily redeployed. As one of the UK's leading providers of total property outsourcing solutions, the consortium had the in-house expertise and was better placed than the DSS to find solutions to redeploy the estate. In the past, the performances of the DSS in this field were quite poor. Just before the transfer, the vacant space was spread over some 140 locations. It concerned 158,000 m² and cost the tax payer over £12 million every year.

The results so far seem to indicate that physical assets was not so specific and that the risk was appropriately estimated. For example, overall development gain share totalled £12 million in March 2001.

Conversely the consortium had to make specific investment to manage the estate and to provide the services required by the contract.

- It created a database that is updated every month to manage the estate. This database is associated with a strategic management and planning tool that was developed by the consortium to manage portfolios and compare alternative proposals for accommodation strategy. Before the DSS did not have any incentives to make such an investment. The accommodation and office services were fragmented between individual business units.
- It established a call centre based in London to handle all calls and work orders from the potential customers in the estate (on average it receives 25,700 calls per month). This customer service centre is crucial for the service quality delivered to the DSS. All the Department's staff can call the centre 24 hours a day. Then the calls are directed to the service

providers. The efficiency of the centre is at the core of the service performance associated with the contract. Work orders have to be handled as fast as possible to avoid penalties.

- Working in the customer service centre requires quite specific skills. The consortium decided to develop in-house expertise by recruiting skilled staff and training them in technical and customer service issues. The staff has to identify the nature of the property service required and to direct the call to the appropriate service providers. This first diagnosis will determine the service quality to the end user. Such an investment was required because the customer service centre is at the core of the performance of the estate management strategy. It confirms that among the skills which contribute to the in-house expertise, human assets are very specific. *“These are probably the most important core skills when moving out of the realm of traditional manufacturing industries. In the service industries human asset specificity is probably the only asset that can give organisations relative advantages. Core skills here are know-how, experience, organizational routines and culture”* (Reeve, 1990, p.140).

All these investments would not have been possible under classical market contracts. A period of three years is too short and not adapted to the features of a transaction that requires specific investment. Because of the 20 years contract the consortium had incentives to develop such specific assets.

4.3. The measurement problem

Measurement issues have been ignored by the empirical literature (Poppo and Zenger, 1998). *“There are two conditions for measures to be effective : observability and verifiability. The first is the possibility for the principal to observe the performance of the agent. The second is the capacity of the principal to verify observations and supply evidence by measures”* (Aubert and al., 1996, p.59).

In the case of PRIME, several procedures have been established to observe and verify how the activities are performed :

- Firstly, the contract detailed all activities to be performed. A Performance Measurement System (PMS) has been established for the 13 services. Then 54 Key Performance Indicators (KPI) have been defined according to the expectations of the DSS. The level of achievement for each KPI is monthly reported for each property. In case of poor performance or buildings unavailability the payments of the Department to the consortium can be reduced. For example, if no heating is available for two hours, the DSS will not pay for the availability of the building that day.
- Secondly, the records and history of all calls and work orders addressed to the Customer Service Centre are contained in an information system that provides service performance statistics.
- Thirdly, several audit procedures have been established and are supported both by the consortium and the DSS to examine all aspects of service delivery across the portfolio. To manage the contract and perform the audit, the DSS still employs about 128 people (instead of 210 before PRIME). The Department can also order external audits and charge the costs to the consortium in case of failure (until a ceiling of £500,000).

- Finally, the consortium tries to benchmark its sub-contractors. For most services and at the level of the whole estate, it relies on two service providers. For example, it is the case for cleaning and maintenance.

5. OUTSOURCING AND THE QUALITY OF THE SERVICE

Customer satisfaction surveys are regularly conducted. In March 2002, the first survey indicated that 87% of DSS staff were satisfied by the level of service provided by the consortium. A further customer satisfaction survey was carried out in March 2003 which resulted in 90% of DWP staff being satisfied with the level of service. No similar studies was carried out prior to PRIME but it seems that the transfer of estate has increased the quality of the service delivered to the end user of the buildings for at least following three reasons :

- The contract allows each partner to develop its own core competencies. The aim of the transfer was to allocate risk to the party best able to manage it.

Before the transfer, the 160 local service contracts were not managed efficiently. Most of them were for three year periods or less. These 160 separate contracts were not standardised and costly to manage (about £5 million a year for staff costs alone). Some directorates gather several services under one single contract whereas others had separate contracts for each service. The management of the services associated with the estate was not the main expertise of the DSS. Conversely, the consortium members were at the origin a property investment fund, property investment specialists and facilities management companies. Its core competencies concern property financing, facilities services, capital project delivery, estate strategy and asset management and provision of new space. Because of its competencies, the consortium was better placed than the Department to manage the 13 facilities services and the disposal of surplus space. Moreover the consortium will benefit from economies of scale. Service providers will buy some components at a lower price than the former sub-contractors of the estate.

So far the consortium has been able to develop an effective estate strategies which meet the needs of the DSS and to reduce maintenance costs by investing in the refurbishment and the renewal of the estate.

It seems that by transferring the responsibility for managing the estate to the consortium, the Department started to concentrate its resources on its core business : the management of the Social Security system.

- The consortium had to comply with the requirements of the contract. Before the transfer of its estate, the Department did not have sufficient resources to refurbish and to maintain the estate. Statutory requirements such as compliance with health and safety legislation were not fully met⁵. The estimated cost to fully comply with the legislation was £9.7 million of work. The contract provides for refurbishment and maintenance of the estate by the consortium. For example the consortium had two years to

⁵ The Department already undertook all Category 1 health and security checks.

comply with statutory requirements and he still has to support risk of non-compliance.

- The length of the contract enables the consortium to make specific investment. It also provides partners with opportunities to learn from one another. It contributes to the establishment of common codes of information between partners. By providing the DSS and the consortium with an identical set of references, it favours communication, develops the stability needed for exchange and enhances the efficiency of coordination. For example, the consortium and the DSS develop several Estates Committee Structure to resolve contractual issues, to discuss service and property related issues and to address local issues of customer concern.

The features of the PRIME contract also lead the consortium to sign long-term contracts with its service providers. Contracts between the consortium and its sub-contractors were initially signed for three years with a possible extension for two more years. In 2003, the contracts ended but the consortium decided to sign a new contract for 15 years with each of its service providers. The aim of these unusual and long term contracts is to enable the service partners responsible for maintenance, catering, security, cleaning, equipment maintenance and furniture to invest in the service.

For example, the security company developed an access control system with the consortium. It was in charge of the development of the software. It would not have invested in this system and make the right commitment to the partnership without long-term agreements with the consortium. Five years are usually too short to recover the initial investment.

Even service providers tend to cooperate together. Initially, there was no partnering between competitors (two service providers). But as time goes, they tend to share their best practices for their mutual benefits. For example, one company changed its way to operate with the help desk by adopting its competitor solutions.

On the long run, these elements should contribute to an increase of the quality of the service.

Despite the increase of service quality and the global satisfaction with the level of service provided by the consortium, some critics remain : Despite the procedures established to measure the performance of the consortium, there is still a problem to define the output and to measure the quality of the service. It appears more difficult to define a service than a product. For some services such as cleaning, there is a lack of tangible indicators. So it appears that the consortium is rewarded according to its compliance with method statements (for example its frequency of cleaning) and its ability to respond in time (and not always for the quality of the service).

This confirms that services are difficult to determine a priori. "*Each service transaction may be considered as unique as long as it is produced on demand (tailor-made) in interaction with the client or as a response to a specific, not standardisable problem, and in different environments*" (Sundbo and Gallouj, 2000, p.44).

PRIME also shows the difficulties to have the same measurement performance system for about 700 buildings, located everywhere in the UK and having different characteristics and end users.

6. CONCLUSION

In this paper we proposed a theoretical framework to analyse the way the UK Department of Social Security transferred its estates to the private sector. According to the transaction theory, outsourcing and long term agreement characterised by high asset specificity can be efficient when uncertainty and measurement problems are low. It appears from the analysis that several procedures have been set up to measure the performance of the consortium and that uncertainty has been mastered through information disclosure, the measurement of the buildings and the evaluation of the assets. The time and the money spent to get reliable information before the implementation of the deal, reduced contractual incompleteness. This could be considered as a success factor. The contract is one way to "enforce" the trust between partners and to limit opportunism (Brousseau, 1997).

The length of the contract appears so far as another source of success. It led the private consortium to innovate and to take risks that he was able to handle. Then the consortium also established innovative arrangements with its service providers by signing long-term contracts. Without such long-term agreements, it is doubtful that the partners would have made specific investments. After five years, this win-win strategy seems to have contributed to a better service performance.

On the basis of this analysis, the PRIME project appears to be quite successful. But further research would be necessary. Indeed, the STEPS deal that started in 2001, was similar but not as successful (NAO, 2004) due to ex-post opportunism of the consortium.

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