PUBLIC ACCOUNTS COMMITTEE

INQUIRY INTO FIONA STANLEY HOSPITAL

TRANSCRIPT OF EVIDENCE
TAKEN AT PERTH
TUESDAY, 25 OCTOBER 2011

SESSION TWO

Members

Mr J.C. Kobelke (Chairman)
Mr J.M. Francis (Deputy Chairman)
Mr A. Krsticevic
Ms R. Saffioti
Mr C.J. Tallentire

Hearing commenced at 11.30 am.

MARNEY, MR TIMOTHY MICHAEL
Under Treasurer, examined:

The CHAIRMAN: Thanks, Tim. I have some formalities to go through. On behalf of the Public Accounts Committee, I would like to thank you for your presence before us today. The purpose of this hearing is to assist the committee as it gathers evidence for its inquiry into the decision to award to Serco Australia the contract for the provision of non-clinical services at Fiona Stanley Hospital . At this stage, we would like to introduce the committee, but I think you know all the members of the committee.

The Public Accounts Committee is a committee of the Legislative Assembly of the Parliament of Western Australia. This hearing is a formal procedure of the Parliament and therefore commands the same respect given to proceedings in the house itself. Even though the committee is not asking witnesses to provide evidence on oath or affirmation, it is important that you understand that any deliberate misleading of the committee may be regarded as a contempt of Parliament. This is a public hearing, and Hansard will be making a transcript of the proceedings for the public record. If you refer to any documents during your evidence, it would assist Hansard if you could provide the full title for the record. Before we proceed with questions that we have today, can I ask a series of questions? Have you completed the "Details of Witness" form?

Mr Marney: Yes, I have.

The CHAIRMAN: Do you understand the notes at the bottom of the form about giving evidence to a parliamentary committee?

Mr Marney: Yes, I do.

The CHAIRMAN: Did you receive and read the "Information for Witnesses" sheet provided with the "Details of Witness" form today?

Mr Marney: Yes.

The CHAIRMAN: Do you have any questions in relation to being a witness at today's hearing?

Mr Marney: No, I do not.

The CHAIRMAN: Thank you for the submission which Treasury provided to the committee.

Ms R. SAFFIOTI: It is very long.

The CHAIRMAN: From that we take it that it was really just an oversight role. Perhaps to start you might like to just clarify for us the role you and your department play in the Serco contract.

Mr Marney: There are probably three distinct points of involvement. At the time the services were going to tender for expressions of interest and then later into the full contract process, the government procurement area of the now Department of Finance actually sat with me in the Department of Treasury and Finance. They had a role in advising in the process and ensuring that the procurement process that was followed was sound, the evaluation process was clearly articulated prior to evaluation and documented and so on. So there was a specific procurement process oversight role. At the same time the strategic projects area of Department of Treasury is heavily involved in the delivery of the hospital itself, so we also had a role in the process to ensure that the operations of the facility are linked in an appropriate way into the actual construction of the facility, so there is a project management interface with strategic projects.

The third point of involvement was with respect to, if you like, a core Treasury role when the contract came through for the government's approval in assessing whether or not it provided value for money for the state and providing advice through to the Economic and Expenditure Reform Committee and cabinet on that question. Those are really the three areas of involvement.

The CHAIRMAN: If I can just follow up on your last point there, the value-for-money assessment, that basically relied on the public sector comparator or were there other factors involved?

Mr Marney: It was pretty much driven by the public sector comparator and comparing it to the cost of the contract and also, standing back from that, looking at the risks associated with the whole thing—both the risks associated with traditional operation and the risks associated with the proposed contract and, not built into the financials but standing back from that, from a Treasury perspective, our capacity to actually manage a contract of that nature, or Health's capacity to manage a contract of that nature, and any of the elements of vulnerability in the contract itself that would expose the state down the track.

[11.30 am]

The CHAIRMAN: Did that involve giving advice in terms of how Health would either have to put in place new arrangements or add to its capability to be able to manage the contract?

Mr Marney: I am pretty sure we advised along those lines. This is a very large contract, obviously, for significant essential services, and the contract management capability is very different from what we have in place at the moment.

The CHAIRMAN: So can you elaborate in terms of what were the some of the aspects of what was being proposed, so that Health might actually have the capacity to manage the contract as well as possible?

Mr Marney: That advice was given as part of our advice to ERC and cabinet. That was some months ago, so my recollection around that is a bit vague, I have to say, but essentially the onus was put on the Department of Health to demonstrate and put in place the necessary arrangements to ensure that the contract would be managed in a robust and effective way. It was really put in their court to come up with the appropriate measures.

Mr C.J. TALLENTIRE: Just on this issue of shifting risk to the contractor, what safeguards did you see were in place to ensure that in the event of some catastrophic event, such as a serious infection control breach, that the risk would not come back on the state?

Mr Marney: In broad terms, the risk always is with the state because if something like that goes wrong, it is the state that is accountable, regardless of whether or not they have contracted out the actual delivery. Ultimately, if something goes wrong, it is a state contract for service; it is a state facility. The contract, as I understand it, has a range of penalty arrangements in place for those sorts of events. Presumably—that is part of the contract management role—we would know about whether or not there is heightened risk of a catastrophic event long before that event occurs, and manage that risk. So I would anticipate there would be certain performance requirements within the contract that would start to be breached over a period of time, prior to any catastrophic event, which is why contract management is so important to monitor performance against the various targets. My understanding at an operational level is that the targets in the contract are quite extensive and demanding. If you compared them relative to our existing facilities, they are probably more demanding than what we place on ourselves in the other hospital facilities.

Ms R. SAFFIOTI: Can I ask about the cost of the contract? There are two parts. First of all, the public sector comparator, which we will get into in some detail soon, but the actual cost, is that being provided for in the state budget?

Mr Marney: My understanding of the cost is that the cost of the operation of Fiona Stanley Hospital, as articulated to me by the Department of Health and the Minister for Health, is covered by the existing clinical services framework and will be accommodated within the activity-based funding arrangements introduced by the Department of Health for the current financial year. So the short answer is their answer to me is yes.

Ms R. SAFFIOTI: For the current financial year, but the forward estimates, given that Fiona Stanley is going to be fully operational in April 2014, would you envisage they will need a budget adjustment to accommodate Fiona Stanley?

Mr Marney: The indication from the Department of Health to me is that no, they do not require a budget adjustment.

Ms R. SAFFIOTI: So it will be accommodated within the forward estimates.

Mr Marney: That is their indication to me.

Ms R. SAFFIOTI: Are you confident about that?

Mr Marney: I can only take their word and do everything I can to ensure that that is the outcome.

The CHAIRMAN: Given that there are only a limited number of years which would currently appear in the forward estimates, given the 2014 start up, do you have any concerns that perhaps the cost loading may be pushed out into other years and that there could be factors in the contract, if you are familiar with it, that may mean that the costs will actually ramp up beyond what you expect in the forward estimates?

Mr Marney: There is nothing in the contract that Treasury has come across that heightens any, if you like, back-ending of cost in that contract. So, no, there is nothing of concern in that regard.

Ms R. SAFFIOTI: Back to the total budget and clinical services framework, that outlines how many emergency beds you have and how many other operational beds you have. If there is going to be no reduction in Royal Perth—from your understanding, will there be a reduction in the operations of Royal Perth in 2014 to accommodate the start up of Fiona Stanley?

Mr Marney: My understanding is that within the clinical services framework there will be a reconfiguration of activity across the system, whether that is Royal Perth or Charlies or Fremantle; I would expect it would be a combination of that. That plus the growth money that is already in the Health budget out in the forward estimates is how Fiona Stanley will be funded.

Sorry, I did miss out a bit in that translation between the clinical services framework and the activity-based funding. The whole-of-health cost model sits between those and actually costs the clinical services framework going forward and then the activity-based funding distributes the funding to bring the two together.

Mr J.M. FRANCIS: Following on from John’s question, did Treasury do any modelling, or was it done by Health; and, if so, was it on the savings to the Western Australian taxpayer for outsourcing all these services? Had they not been outsourced and done entirely by the government—there is a whole list of those services—how much more would it have cost and how much are the savings by outsourcing the this contract?

Mr Marney: That modelling was undertaken by Health using the Treasury guidelines for public–private partnerships. Through the public sector comparator, that would articulate what we think it would cost the state to provide those services itself. That was then compared against the cost of the contract, with appropriate risk weighting on both sides of those and the use of discount factors. That demonstrated that all of that work was done by Health, with the appropriate consultants involved, I assume. It was cross-checked by us, in terms of a rule of thumb—does this make sense—and that demonstrated savings over the life of the contract in the hundreds of millions.

Ms R. SAFFIOTI: Can I just ask, did DTF go through the actual analysis or just the principle of it, for example, to ensure that yes, all these components are ticked off, or did they actually go through the raw numbers? We understand that a private consultant was hired by Health. I am just wondering what level of detail did Treasury go through the public sector comparator?

Mr Marney: I think we went through the modelling of the public sector comparator in some detail, so not just a stand-back principle, see what is written; we did have access to the modelling of the public sector comparator. I would have to get back to you on precisely how far we went in terms of the checking of the figures. My sense is that we did a reasonableness check on particularly the risk adjustments in the discount rates to make sure that they did not seem silly.

The CHAIRMAN: Can we try to get into a bit of detail there? The Treasurer has put on the record in the Parliament that there was a $300 million saving due to the transfer of risk from the state to Serco. Can you give us an understanding of how you actually quantified that risk transfer to come up with the $300 million figure?

Mr Marney: Yes. Part of the process of establishing the public sector comparator and then evaluating the benefit of the contract is to understand—part of the whole point of this is transferring risk, so the hardest part of the whole process is understanding what that is worth. That is where the hardest part of the judgement, in terms of what is in the public interest, lies in the whole process. So the estimation of what that risk is worth is the modelling that Health did through their consultants—I think it was Paxton. So, in terms of process there is usually a risk workshop where all the risk of this service delivery is articulated and a value put to that, and then what risk is being transferred as part of the contract is separated out of that because it has a value assigned to it from our perspective and we therefore know what risk is being transferred, and, if you like, the notional saving that goes with that. So it is not an actual dollar saving; it is a saving of what might happen.

[11.45 am]

The CHAIRMAN: How does that lead to a quantification of that into dollars?

Mr Marney: All that gets fed into the public sector comparator and is valued with appropriate discount rates. There are base risks in the service delivery that are in the discount rate applied to the public sector comparator, and the same discount rate is applied to the contract to treat like with like. That then gives a cost of the service to the state, including risk, over the life of the contract, and then that is compared against the contract.

The CHAIRMAN: Are you aware of any quantification of the additional risk to government of contracting out?

Mr Marney: The additional risk to government of contracting out is not quantified. I will check that, but I am pretty sure it is not quantified because that is a risk that can be mitigated. So the penalties in the contract are what compensates if something goes wrong. While there are risks associated with contracting out of those services, those risks are mitigated through the penalty arrangements in the contract.

The CHAIRMAN: There was also a suggestion that almost $70 million would be saved due to the adjustment for competitive neutrality. I would like to get some understanding of why competitive neutrality should be applied in a contract such as this in Health.

Mr Marney: To compare like with like in terms of the cost with service, obviously an external provider would pay payroll tax; the internal provider does not. So to make sure we are comparing apples with apples, the adjustment for that is made. I think that is the only element of competitive neutrality in the formula.

Ms R. SAFFIOTI: I thought competitive neutrality, which I raised in the previous session, was brought in through the competition policy.

Mr Marney: It was mainly aimed at —

Ms R. SAFFIOTI: GTEs running businesses that are competing with the private sector.

Mr Marney: Yes.

Ms R. SAFFIOTI: In a sense, if we look at the public sector comparator, there is the raw PSC, which is the actual cost. There are always adjustment for competitive neutrality and what government would pay if it was a private entity and then all these risks with some sort of artificial allocation of value. In assessing this contract, in a sense, saying that you are going to save X millions of dollars, you are not really saving those X millions of dollars because it is a potential of saving X million of dollars if all these risks occurred and we valued them correctly. That is how I see it; it is not an actual saving.

Mr Marney: It is not an actual saving full stop, because there is no service at the moment. It is a question of estimating what the cost of the services would be.

Ms R. SAFFIOTI: Could be!

Mr Marney: Could be—but obviously those risks have a cost associated with managing those risks. The value or the cost of those risks is not the cost of them actually being realised; it is the cost of having to manage them over time, which is an actual cost in service delivery.

Ms R. SAFFIOTI: Yes; in the managing of risk, but not the actual fulfilment of that risk, in a sense. This is not only managing the risk, but a fulfilment of something going wrong too, as I understand it; it is a transfer of risk.

Mr Marney: It is a consequence.

Ms R. SAFFIOTI: Yes, it is a consequence. But also in respect of competitive neutrality, which I have a problem with in this instance, and the application of $70 million to the government contract, in a sense the government option is that the government would not pay that $70 million; it is not an actual cost.

Mr Marney: I understand your point. My recollection is competitive neutrality is a requirement of the national PPP guidelines to factor that in. But you are right, it is a $70 million cash cost that the government would not pay. Having said that, the deal does not stand or fall on the basis of that $70 million. Your comment around risk is right: it is the cost going forward, assuming some additional costs associated with both managing or dealing with the consequence of a certain set of risks. As you have highlighted, this is the most problematic area of establishing whether or not a public–private partnership is superior to public provision, in a traditional sense.

Ms R. SAFFIOTI: This is my last question on risk, which I raised in the previous hearing on the transfer the other way. In my view, and from what I have seen in government over the years, you can never transfer all your risk and the fact you are contracting out is a risk. It is a risk because of issues to do with performance not being met and how to deal with those consequences. The second part is you are not in control of the corporate structure of that private company, so there are things that happen in the private sector every day, as we know, that impact on government service delivery. That is another part and I think to be real about transfer of risk allocation there needs to be a risk allocation the other way, saying that there are things beyond our control and if something happened tomorrow with this company where would it leave government. That is just a point, rather than a question, I suspect.

Mr Marney: Arguably, and as you would know from your experience in government as well, the degree of control government has over change and culture in the public service can be challenging at times also.

Mr C.J. TALLENTIRE: I have a further question on risk. Would it be fair to say that the potential cost saving between the Serco approach versus the state-controlled approach is a reflection of the degree of diligence that the state would put into avoiding a potential problem versus the effort that Serco would put into avoiding a problem?

Mr Marney: It is probably not an issue of diligence or effort but of incentive. If you like, in a traditional bureaucratic structure, those sorts of risks end up back on the consolidated fund, so the incentive for the governing bureaucracy to manage those risks and also the capability is probably not what it is in the case of a private contractor, who is up against real financial penalties if those risks are realised. It is more the incentives and the capability.

Mr A. KRSTICEVIC: Are you saying they would have a greater incentive and be more capable than if it was managed by the public sector?

Mr Marney: Yes, and the whole point is there is a dollar in it, and if those risks are realised there are dollar consequences. Whereas in the public sector those consequences are far less tangible.

Mr J.M. FRANCIS: While we are on the subject of estimating costs and risks, it is Labor policy, if they win the next election, essentially, to rip up this contract. The next election is in March 2013 and the hospital is due to open in April 2014. Has Treasury done any estimation of what it would cost the taxpayer if this contract were ripped up, both in terms of paying out Serco and also somehow suddenly quickly amazingly re-employing all these people in the public system?

Mr Marney: We do not normally cost the election, pre-election or policy statements of oppositions, so the answer is no.

Mr J.M. FRANCIS: Obviously paying out this contract would be expensive.

Mr Marney: It is a large contract. How one would exit that is really a matter for the State Solicitor.

The CHAIRMAN: I will come back to the savings which have been suggested of $500 million. Another component of that was $148 million raw cash outlay saved. Can you give us some explanation of what that means?

Mr Marney: I would have to get back to you on the detail associated with that. I do not have that breakdown with me.

Ms R. SAFFIOTI: It was a figure used by the Treasurer, just to give you some background, in the Parliament and we are trying to find out exactly how that figure was derived, and we cannot. Could you provide by way of supplementary information how that $148 million cash saving was arrived at?

Mr Marney: I am happy to do that. The number is accurate, but I do not have the breakdown with me, unfortunately.

The CHAIRMAN: If you could give us some understanding of how it was derived and what it stands for.

This is a more general economic question that obviously underpins when you contract out: what would you see as the current interest rate differential between public sector borrowings and private sector borrowings?

Mr Marney: I would have to give you that as supplementary information based on our current borrowing rates.

The CHAIRMAN: Obviously in the private sector there would be a fairly wide spread, depending on the risk involved.

Mr Marney: Yes.

The CHAIRMAN: But if someone was contracted to government, which is generally seen as a fairly good area in which to get a contract, at what sort of market rate would they be borrowing compared with the rate at which Treasury can borrow?

Mr Marney: I will provide that as supplementary information based on our current Treasury Corporation borrowing rates, and I will give you some benchmarks on bond market rates as well.

The CHAIRMAN: The House of Commons Treasury committee brought down a report just a few months ago suggesting that in the UK there was a three to four percentage point differential between government and private sector borrowing for government projects. I would be interested to see how that compares with Australia.

Mr Marney: I would be very surprised if it was that large.

Ms R. SAFFIOTI: I have a general question about flexibility of contracts and the fact that this is a 20-year or a 10 plus five, plus five contract. We have seen historically what happens when government locks in for 20-year contracts and the level of flexibility that gives to government from year to year to manage their services within budgets. From a Treasury point of view on the issue of the more these types of contracts are struck the less flexibility government has from a day-to-day sense—there is a question mark at the end of that!

Mr Marney: The flipside of that is you have more certainty over costs as well, because you know what you are up for as opposed to other areas, for example, in the health system, where the certainty of such costs is dramatically lower. I think the key in managing, if you like, that risk is to have a variety of arrangements in place as we do, for example, in the prison system where we have a mixture of some private provision and predominantly public provision in Corrective Services. That also give us some benchmarks as to what our costs should look like on a reasonable basis, but ensures that we have enough flexibility in the system to deal with emerging pressures.

Ms R. SAFFIOTI: Does that not mean when there are existing contracts—you were talking about prisons and health—where if there are issues—for example, the efficiency dividend that was applied—these contracts always stand alone. That efficiency dividend can never be applied and therefore, for example, the facilities management of the hospital will not be subject to the efficiency dividend, whereas the clinical services could be. It actually reduces a lot of flexibility.

Mr Marney: Yes. Arguably we have already extracted the efficiency dividend up-front though, because there is that margin of lower cost in the contract.

Ms R. SAFFIOTI: Perceived lower cost; it is not actual lower cost.

Mr Marney: An estimated lower cost. But you are right, and when you lock away chunks of service in long-term contracts it reduces your ability to extract money at will, which is quite a frustration for Treasury officers. Work contracts in roads is a classic example. An example is also where we have robust contract management. You can have the best contract in the world, but robust contract management on an ongoing basis is essential, otherwise it all goes to crap.

Ms R. SAFFIOTI: Will the contract price always be driven by factors like indexes, whether it is labour force or price indexes, which are beyond government control?

Mr Marney: Yes.

The CHAIRMAN: Are you aware of the indexation factor in the contract; and, if you are, can you comment on it?

[12.00 noon]

Mr Marney: Not offhand.

The CHAIRMAN: Coming back to the public sector comparator, you mentioned Paxon as the consultants who advised on this: does the government have a panel of accounting companies and consultants who are approved for doing public sector comparators, or how do you acquire companies to take on this work?

Mr Marney: In this circumstance it was tender processes run by the Department of Health and it obviously requires someone with some background in the operation of health facilities and a good understanding of how they work and how they digest money. We have broad common-use arrangements in place for commercial, financial and accounting expertise and advice. Often that will do the trick; we will be able to find someone out of those common-use arrangements with sufficient capability, but sometimes it requires tender processes over and above that or outside of that common-use setting where it is particular specialist areas. It is a mixture.

The CHAIRMAN: Can I come back to the mechanism involved. In terms of your common-user contracts or accreditation, are there a number of companies in Perth which you would judge to be competent to do public sector comparators, or are you really on a case-by-case basis testing the market to see who can do it?

Mr Marney: There are a few around that we know are up to it. There are others from time to time with greater expertise that it is worth sourcing to ensure we get the public sector comparator as robust as we can because, as has been pointed out, it can be a slightly theoretical exercise. The contract or the decision to provide traditional in-house or to outsource can swing on those assumptions and those estimates.

The CHAIRMAN: When you say there are a few around, are we talking two or three or perhaps a few more than that that you would have confidence in going to at the current time?

Mr Marney: There are probably four or five that we would have confidence going to.

The CHAIRMAN: Given that there is a bit of an appetite for contracting out, how many contracts are let currently across governments that you are aware of for advice going directly to public sector comparators?

Mr Marney: It is a very limited number. It tends to be associated with new infrastructure rather than existing services. I am not aware of any proposals being evaluated to outsource existing services. It is where a substantial new facility that we are trying to ascertain what is the best way, in the public interest, to operate and deliver services from the new facilities

The CHAIRMAN: I understand that, but the point of my question is to get some understanding of the strength of the services available by consultants to advise on public sector comparators.

Mr Marney: Again, I can provide that by way of supplementary information, if that is okay, to give you a more considered assessment of the market and also how we use local and interstate expertise. A lot more of this activity has been undertaken on the east coast. We tend to draw on that expertise where similar activity has been undertaken over east.

The CHAIRMAN: I would appreciate, in terms of that supplementary information, if you could provide, if it is interstate as well, the actual companies and the work that they are known to have done, to get a list in the last two or three years who has been engaged to work in this area of providing advice on public sector comparators.

Mr Marney: Yes. I am happy to do that.

Mr C.J. TALLENTIRE: Would you expect that the PSC would have been provided prior to cabinet endorsement—that it would have been a part of the submission to cabinet?

Mr Marney: Absolutely, because the contract needs to be compared back to something to know whether or not it is good value for money. It is closely guarded during the tender and evaluation processes, and contract negotiation processes, for obvious commercial reasons, but fully disclosed to inform government’s decision making. I would expect, after the dust has settled, that it would be appropriately disclosed publicly as well.

Mr C.J. TALLENTIRE: You do not know when the PSC was finalised for Fiona Stanley Hospital?

Mr Marney: I am not sure offhand, no.

The CHAIRMAN: Can I just confirm that when you said “when the dust has settled”, my understanding of current policy—I do not know whether it is government policy or Treasury policy—is to potentially release information six months after the signing of the contract.

Mr Marney: Correct.

The CHAIRMAN: Could you correct me on that or state what the actual policy is?

Mr Marney: That is correct.

The CHAIRMAN: Is it taken that after six months whatever would be available in terms of technical detail in the public sector comparator would no longer have commercial value for other projects that might be afoot?

Mr Marney: We would assess at the time just to see what else is going on, if you like, and if there are other active negotiations in place, as to whether or not it would compromise any of that. If it does not, then my advice would be that it would be fully disclosed.

The CHAIRMAN: It is a case-by-case decision?

Mr Marney: Yes, but there needs to be as much transparency as possible around these arrangements so that the Parliament has confidence that what is being done is in the public interest.

The CHAIRMAN: That is certainly our view.

Thank you very much. We have some brief formalities to close this hearing. Thank you for your evidence before the committee today. A transcript of this hearing will be forwarded to you for correction of minor errors. Any such corrections must be made and the transcript returned within 10 days from the date of the letter attached to the transcript. If the transcript is not returned within this period, it will be deemed to be correct. New material cannot be added via these corrections and the sense of your evidence cannot be altered. Should you wish to provide additional information or elaborate on particular points, please include that as a supplementary submission for the committee's consideration when you return your corrected transcript of evidence. We would also appreciate if you are able to provide that information which you undertook to provide as supplementary information. Thank you very much.

Hearing concluded at 12.06 pm