STATE OF UTAH
Free Market Protection and Privatization Board

PROCESS FOR EVALUATION OF ALTERNATIVE SERVICE DELIVERY STRATEGIES

April 2015

State of Utah

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Governor

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FREE MARKET PROTECTION & PRIVATIZATION BOARD

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Chair

April, 2015

To State of Utah agencies:

The Free Market Protection and Privatization Board was established by the Utah State Legislature and appointed by the Governor to review government services and make recommendations for the effective privatization of government services where services can be effectively and efficiently delivered by private means.

The Board determined that it needed a workable process for the identification and evaluation of potential privatization opportunities. Therefore, it engaged Sequoia Consulting Group to develop a set of principles, assessment tools, strategies, and approaches consistent with the Board's statutory duties. This manual is the result.

Consistent with statute, the use of the methods detailed herein will enable the Board or any agency to review and evaluate specific government services and determine possible service delivery alternatives where privatization is found to be feasible and desirable. We believe we have developed a process that will result in recommendations based on practical, economic reasons rather than political expediency.

The Board wishes to thank Dr. Ken Murray and Ms. Anita White from Sequoia Consulting Group for their expertise and efforts. We thank also the many state employees from a variety of agencies who participated in interviews, exercises, and other activities which informed the process we have developed.

We invite agency leaders to make use of these methods as tools in the delivery in services to Utahns.

Respectfully submitted,

Kimberley Jones

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INTRODUCTION

For the past decade, the State of Utah has maintained a program to assess its public services to determine which are inherently governmental in nature and those which might lend themselves to privatization. The work is performed under the auspices of the Utah Free Market Protection and Privatization Board, supported by the Governor's Office of Management and Budget. As part of the legislative requirements, the Board semi-annually issues a list of activities which fit these categories, the most recent list having been issued in November 2014.

With the authorization of new State law in 2013, the Board wants to expand the privatization review to develop a systematic approach to evaluating whether a public service should or could be privatized, an objective determination of the value of privatization, and a means of addressing complaints by private businesses that the government is unfairly competing.

The following document includes a detailed approach to evaluating services for privatization potential. This document is the result of the work of the Privatization Process Advisory Committee of the Free Market Protection and Privatization Board (the Committee).

The Committee and staff from the Governor's Office of Management and Budget retained Sequoia Consulting Group to draft this document. Sequoia is a consulting firm that specializes in working with State and local governments in the areas of performance improvement and cost analysis. The Sequoia project team included highly experienced professionals with both operations and cost analysis backgrounds, with extensive backgrounds in alternative services.

This document represents a detailed strategy for analyzing privatization potential. Even so, it will be important to maintain flexibility in approaching this analysis. In some cases, a quick decision will be required and the time available to assess an option may require that the State shortcut some of the analyses. In other cases, the issues of concern may be unique and not addressed in this manual. In order to have the ability to address the greatest number of options, the State should allow flexibility in the use of the processes identified in this manual.

While this document was developed to assist the Free Market Protection and Privatization Board in its duties, the process described may also be used by agencies and departments to evaluate their own services and inform users considering alternative service delivery strategies.

Guiding Principles for Utah's Free Market Protection and Privatization Board

1. The goal of this project is to develop a set of principles, assessment tools, strategies, and approaches, consistent with the Board's Mission Statement, that enables the State to:

- Increase the quality and timeliness of services.
- Improve the efficient and/or effective delivery of services.
- Decrease the costs of services.
- Eliminate or reduce unfair competition.
- Protect the tax base of the State.
- Broaden the revenue base of the State.
- Further the overall mission and goals of the State.
- Continue appropriate protection of the State's vulnerable citizens (e.g., children, elderly, disadvantaged, disabled).
- Continue protection of data and information as required by State legislation and regulation, as well as Federal rules and regulations.

2. Privatization for the purposes of this project will be defined as alternative service delivery, including:

   - Contracting out or outsourcing—the government contracts with a private organization (whether non-profit or for profit) for the delivery of all or part of a service.
   - Public-Private Competition—governmental services are open to competition; the government may bid to continue to provide services, but must compete with other interested bidders.
   - Public-Private Partnership—governments may work cooperatively with private organizations (whether non-profit or for profit) to provide services.

   While these are the most common approaches to alternative service delivery, they are not the only options. Appendix A of this document presents, in alphabetical order, a more comprehensive list of options for alternative services.

3. In order to broaden the State's privatization approach, a comprehensive set of "privatization" reviews should consider at least the following strategies:

   - Using assets to increase revenues.
   - Improving efficiency, quality, and responsiveness of services.
   - Joint public-private financing and development of facilities and other infrastructure.
   - Enhancing the economic performance of government-owned and operated facilities.
   - Using good business practices, such as enhancing cash management and restructuring debt.
   - Disposing of unprofitable government-owned "companies" or making them more profitable.
   - Shedding unnecessary services.
   - Using vouchers for clients to purchase services from the private sector.
   - Granting authority to a private sector firm to provide services through a franchise.
   - Leasing equipment or facilities.
   - Removing or reducing regulations for private sector entities.

- Providing services with volunteers.

4. In order to implement successfully a comprehensive privatization strategy, the following major lessons from previous privatization efforts, should be considered:

   - Privatization decision-making needs an organizational and analytical structure and cannot rely solely upon political philosophies of decision makers.
   - It may be necessary to recommend legislative and/or budgetary changes to encourage appropriate use of privatization.
   - Reliable and complete cost and performance data are needed to support privatization decision-making; therefore, assessment and monitoring tools are needed to analyze and implement privatization strategies.
   - Strategies may need to be developed for the transition to privatized service operations, including whether State employees will be allowed to bid, whether bidders will be required or encouraged to hire former State employees, etc.
   - Contract monitoring and/or project oversight will be vital elements for any privatized service or strategy.
   - It will be important that departments of State government realize that some policy options that are in the public's best interests may be contrary to the self-interests of the State's departments and employees.
   - It is also important that the State communicate with employees and make a commitment to fair treatment of those employees, as privatization strategies are investigated and implemented.

5. Although this manual and the approaches it details may be formally accepted into rule or approved legislatively, it is still important to allow the State flexibility in testing and analyzing a wide variety of options. It is important that new privatization and analytical approaches be accessible to staff and the State be able to have the flexibility to test new options.

6. The analyses developed in this document are also intended to address unfair competition. A condition of unfair completion exists when either the governmental agency or a private business gains a financial advantage as a result of statutory authority. Examples, but not an exclusive list, of such conditions include tax free authority, absence of a requirement for bid bonds or performance bonds, regulatory licensure and fees or exemption therefrom, limitations or constraints on competition such as requiring that work be done by either a public or private organization.

   In other words, should legislation exempt, for example, the government from paying taxes, private businesses who do pay taxes, might show higher costs unless the taxes are considered appropriately in identifying any advantage of having the private business perform the service. The cost analysis has been structured to address such unfair competition and to find ways to mitigate the impacts of unfair competition.

GOVERNMENT TRENDS IN PRIVATIZATION

There are numerous examples of successful privatization efforts. One of the leading organizations tracking privatization is the Reason Foundation. The summaries of various efforts in this chapter come principally from the June 2014 Reason Foundation's 2014 Annual Report on Privatization as well as various other sources At the Foundation's website (http://reason.org), annual reports are available from 2005-2014. It would be prudent to review each of these reports, as they assess difficulties that have arisen from various privatization approaches and methods, as well as the successes of various approaches and methods. The following summary is intended to illustrate some of the information available in these publications, for future reference.

State Lottery Management

Forty-four states operate lotteries and all currently outsource some aspects of lottery operations. Due to the recent recession, some states (Illinois, Indiana, and New Jersey, for example) have entered into private management agreements (PMA's) apparently focused on increasing State revenues from lotteries. Pennsylvania began work on a PMA with a United Kingdom firm; however, the Attorney General turned down that agreement which included some products not yet legal in the State. It is assumed that more work will continue in Pennsylvania on a PMA. Revenues resulting from Illinois and Indiana PMA's have increased, but have sometimes failed to reach the contracted amounts.

South Carolina and Oklahoma have both begun investigation into legislative authority for soliciting bids for PMA's; however, in both cases, legislation has stalled.

Social Impact Bonds

Social impact bonds (SIB's), a new public-private partnership concept, pioneered in the United Kingdom, are being analyzed by many governments. The concept is based on private sector funding intended to support social service performance-based models. The Kennedy School at Harvard University sponsored a competition for SIB's and the City and County of Denver, as well as the states of Connecticut, Illinois, New York, Ohio, South Carolina, and Michigan have received some funding for technical assistance, including the development of systems to measure program performance.

In addition, the US Department of Labor awarded funds to the states of New York and Massachusetts to support pilot projects to reduce recidivism among recently released prisoners. It is important to note that these bonds are not government-issued financing structures, but contacts with private investors who fund program start-ups.

In Utah, the United Way of Salt Lake and private foundations announced an SIB program and a pilot project is currently underway for early childhood education.

SIB's are relatively new approaches to privatization so it will be important to review the results of projects and determine when and how to utilize these new approaches.

State Liquor Privatization

Several states have undertaken liquor privatization projects. Utah is not currently interested in pursuing this issue; however, the June 2014 Reason Foundation report contains descriptions of the approach taken in the State of Washington, as well as in other states.

Several States Propose Anti-Privatization Bills

In 1993, Massachusetts passed the Pacheco Law, which shut down privatization efforts for the State government. Anti-privatization bills have been introduced in California and other states. In California, three different bills have been introduced:

- California's Assembly Bill 566 was vetoed by Governor Brown because it contained requirements that made it difficult for private firms to compete for court-related contracts

- California's Assembly Bill 906 requires state agencies to notify unions that represent state employees before executing personal service contracts

- California's Senate Bill 556 did not pass, but would have required identifying services being provided by non-State employees on vehicles or uniforms

In 2013, two bills introduced in the Louisiana legislature contained language very similar to the Massachusetts Pacheco Law. These bills were considered a response to the Governor's aggressive privatization policies; however, the bills failed to be enacted. In 2013, the Governor of New Jersey vetoed legislation that contained many Pacheco Law privatization restrictions.

In 2011, the State of Washington passed legislation that required the State Office of Financial Management to identify functions that could be contracted out. In 2014, legislation that would have made it difficult to implement the 2011 legislation was tabled.

Thus, although there have been attempts to restrict privatization, these efforts have not been particularly successful.

Other Issues

Many other issues are addressed in the June 2014 annual report on privatization, including:

- Public-private partnerships for modernizing public infrastructure, including social infrastructure, such as schools;

- Higher education public-private partnerships for a wide variety of services and facilities;

- Child welfare privatization, including a five-year federal waiver that allows Florida to provide more options for serving children; and,

- Reports on both successful and not-so-successful projects across many states, along with analysis related to the reasons for success and ways to address unsuccessful projects

In conclusion, following privatization issues in each state could be a full-time job. Since the Reason Foundation publishes detailed reviews of state and local government privatization issues, it would be appropriate to review these reports when beginning the review of any particular privatization issue.

PROCESS FOR ALTERNATIVE SERVICE DELIVERY EVALUATION

In this section we outline the principal steps to be used in determining whether a given service, or set of services, is amenable to an alternative delivery strategy.

The Process Steps

The analysis of alternative services frequently uses the methodologies employed for internal risk assessment, performance management, and financial management. We integrate those methodologies in recommendations for an evaluation process consisting of the following steps:

1. **Create a long-term assessment plan:**

    - The critical point is that, in any organization, work that is outside of normal routine will not get done if it is not part of a prioritized plan.
    - The Plan establishes priorities for service assessment based on preliminary assessment.
    - The Plan should cover a 2-4 year period, prepared by the Board with input from respective State departments.
    - The Board should update the Plan annually based on annual assessment plan and updated issues identification.
    - The Plan should include alternative service strategies, internal resumption strategies, and potential areas of unfair competition between State agencies and private businesses.
    - The starting point is the Board's inventory of government services, which is required to be compiled and made available to the public every two years.

2. **Prepare annual assessment plan:**

    - The Annual Assessment is based on the long-term plan.
    - The Annual Assessment will include both internal assessments performed by individual departments and external assessments performed under the auspices of the Board.
    - Assessments are distributed among Departments based on plan priorities, immediate issues, and departmental needs.

- Each assessment is reviewed and followed up, led by Board staff, State purchasing staff, and departmental management liaison.

3. For each service, conduct a preliminary assessment:

- The principal considerations for the preliminary assessment review include: mission criticality, performance, perceived reward, perceived risk, and current cost.

- Decisions should focus on services that represent low mission criticality, high perceived reward, low perceived risk, high costs, and low performance.

- In assessing a service for possible alternative service delivery, there are several broadly defined factors that need to be considered. These factors run through all of the analyses described in this manual:

  ✓ **Mission Criticality** represents the importance that a service or function has. If it is a service that is absolutely essential for an organization, then it would be considered critical to the assigned mission of the agency. On the other hand, if it is a service that is optional, then the service would not be considered critical. This is not an either/or consideration; there are many different degrees of importance in any organization. Mission Criticality can be determined by a combination of the Board's service inventory as well as a prioritization survey of the management of the respective department.

  ✓ **Current Performance** is how well an organization is carrying out the given service. It needs to be evaluated on quantified, objective standards. There are several available systems:

    ❖ Ideally, the best source should be the State's SUCCESS Framework, to the extent possible. However, it will probably not have the programmatic level of detail necessary for this analysis.

    ❖ A second source is external work reporting. Most State agencies have some form of federal reporting requirement. The requirements are usually reports of work volume activity of interest to the federal agencies and have limited value as measures of management and organizational performance. Nonetheless, the reports have the advantage of being standardized among States and, with some creativity, can be used to generate some management performance measures.

    ❖ A third source of objective performance reporting are the internal performance metrics that departments might have individually developed and which they use for internal management. A problem with department generated measures is that they lack some objectivity; for that reason, as part of the assessment process, the Board should request that the respective department validate the measures before using them in this analysis.

- ❖ If the State does not collect performance metrics for a specific service, then the respective Department will need to self-assess its performance in conjunction with the Board's assessment.

- ✓ **Perceived Reward** is how much an agency can expect to gain from using an alternative service delivery. Rewards may be any number of a different things, such as financial savings, enhanced revenue, greater service efficiency, or greater public acceptance, as examples. Perceived reward can be identified using the detailed service assessment form included with this report.

- ✓ **Perceived Risk** is the evaluator's estimate of how much risk may be involved in using an alternative service delivery strategy. Risk may include, but is not limited to, such considerations as failure to achieve meaningful cost savings or revenue goals, poor contractor performance, and negative political or public reaction. Risk can be identified using the detailed service assessment form included with this report.

- ✓ **Current Cost** is based on a two to three year assessment of actual expenditures, not budget. A determination of high cost can be based either on comparable costs for similar services or the degree of cost increase over several years relative to the State budget.

The assessment tools in this manual both directly and indirectly address the various considerations just listed. Services which have the higher assessment scores are those which would appear to be most amenable for alternative service delivery. Based on the number of services and staff availability, the higher priority services will undergo more detailed analysis based on the review elements spreadsheet.

4. Conduct detailed review based on evaluation forms in Appendix C:

- The Board could convene an assessment committee, recommended to include some members of the Board and Board staff, a representative of either Department or State Purchasing, and representatives of the respective Department.

- The respective agency and/or Board staff representatives will complete assessment spreadsheet. They can do this working together or separately.

- If the assessment achieves a certain threshold score (to be determined), then the agency and Board staff will prepare an alternative service delivery plan that addresses each category of the assessment, including a plan to ameliorate any perceived problem areas and an implementation plan. The agency will prepare the initial plan, with review and comment from the Board staff. The next section describes the scoring and establishing the threshold score.

- The agency and Board staff will prepare detailed cost assessment plan based on cost accounting methodology.

- If a plan includes the potential for managed competition, it will need to identify potential bidding issues that would be an impediment to fair competition, develop alternative strategies, and secure purchasing and legal approval for changes.

- The Board and respective Department management will review the plans.

5. Draft performance contract for use in Request for Proposals:

- The performance contract is designed to establish specific quantifiable, objective performance standards for a vendor.

- It provides for regular evaluation and approval of service delivery, performance correction, compensation, and termination procedures.

6. Implement the appropriate State procurement procedures.

Analyzing a Service for Potential Privatization

This section establishes the methodology for conducting the evaluation of a specific service. The analysis begins with an assessment of the potential of alternative service delivery strategies for a given service or function. The list below itemizes the various issues that need to be addressed during the analysis. This list is comprehensive, given current knowledge. State analysts should be allowed to add additional elements of review, or ignore inappropriate elements of review. Each individual privatization option will have its own important review elements, but it is also possible that a proposed project will not require an assessment of every item within a particular element listed below.

GENERAL ELEMENTS

1. Is the service being reviewed considered a core or basic service of Utah State Government?

    - Is there legislation requiring that the service be provided?

    - Are there other legislatively established requirements that need to be considered in this review?

2. Do other alternatives exist for providing this service?

- Is the service available in the private sector?
- Is the service available from another government?
- Is the service available from a non-profit?
- How many vendors/governments could provide this service?
- Would there be a way to have this service become a public-private partnership?

3. How would the State replace a provider if costs or performance proved unsatisfactory?
4. What is the expected level of political opposition to privatization of this service?
5. Has this service been successfully privatized by other states?
6. Are there any known legal barriers to privatization?
    - What is the assessed difficulty of changing these legal barriers?
7. Are there any obvious risks to be considered with the privatization of this service?
    - Does the service assist a vulnerable population (children, elderly, disadvantaged, disabled) that could be negatively impacted?
    - Does the service utilize or maintain data which is vulnerable to hacking or inappropriate use that could lead to liability issues for the State?
    - Are there other liabilities associated with this service which need to be considered?
    - Are there ways to address and mitigate the identified risks?
    - What are the estimated costs of risk mitigation?
8. Does a vendor need access to confidential information?
    - Does the State feel comfortable with a vendor having access to this confidential information?

PERFORMANCE ELEMENTS

1. Does this service currently use quantifiable and measurable performance measures?
    - How does State performance of the service currently measure up?

- Does State performance of the service appear to be of high quality and timeliness?
- Do State costs for this service appear to be reasonable?
- Are there recent financial audit-identified issues?
- Are there recent performance audit-identified issues?
- Are there any documented customer service issues?
- Are there unmet maintenance issues for this service which could be avoided through privatization?
- Are there specialized personnel needs that could be better met through privatization?
- Are there specialized equipment or supply needs that could be better met through privatization?
- Have State staff been seen as providing a high level and quality of service?
- If there are no current performance measures, what performance measures should be used? How hard will it be to develop these measures?

2. How difficult would it be to assess the performance of the privatized service?
3. What level of risk would be involved if a privatized service did not meet required performance requirements?
4. Would the State be able to transfer liability to a service vendor in the case of poor performance?
5. Would the State be able to reward or penalize any vendor for performance?
6. How difficult would it be to construct a performance contract for this service?

COST ELEMENTS

1. What are the current costs for providing this service?
2. What percentage of these costs is fixed?
3. What percentage of these costs is variable?
4. How does State service cost compare with privatized costs?

5. How difficult would it be to monitor service costs for a privatized service?

6. What are the estimated costs of contract development?

7. What are the estimated costs of contract monitoring?

8. What are the estimated costs of employee separation payments if this service were to be privatized?

9. Are other State departments paying a part of this service?
   - If yes, would other departments be able to buy services from another vendor for the same or less?

10. Does the current State service have excess capacity that could be sold due to any privatization arrangement?

11. Does the current State service operate any facility(ies) that could be shed due to privatization?

12. What staffing costs could be eliminated due to privatization?

STAFFING ELEMENTS

1. What are the potential impacts on State employees?

   - How many employees are involved in the service privatization?

   - Would/could a privatized service provider be asked or required to employ State staff?

   - How many jobs face elimination?

   - How many requirements would the State pass on to the vendor in the way of labor laws, benefits, etc.?

   - What would be the financial impacts of requiring the hiring of State employees? Of passing on labor law or benefit requirements?

SUMMARY IMPRESSIONS

1. How comfortable would you feel in privatizing this service?

2. Do you think service quality will improve? Or should improve?

3. Do you think costs will decrease? Or should decrease?

4. What form of Alternative Service Delivery seems to best fit this service?

5. Are there other issues which cannot be scored but need to be considered?

In developing this privatization evaluation instrument, the Privatization Process Advisory Committee prioritized the various criterion on a high-medium-low scoring scale with 9 points assigned to high priority elements, 3 points to medium priority elements, and 1 point to low priority elements.

Using the total score for each element, the Committee grouped the elements according to relative priority, from high to very low, and assigned evaluation points to groupings of these elements of review based on five distinct break points. The following table shows the groupings and the evaluator scoring range:

Priority Group	Total Committee Score	Evaluator Scoring Range
High	57+	0-25
Medium High	43-51	0-20
Medium	28-39	0-15
Low	23-25	0-10
Very Low	21-22	0-5

The assigned scoring ranges represent the maximum and minimum possible scores for each evaluation element. The minimum score represents a score indicating that the respective element argues against privatization. The maximum score represents that the element strongly supports the potential for privatization. The table in Appendix B assigns the respective scoring range for every evaluation element, based on that element's relative priority. When conducting the actual analysis, each evaluator uses his or her own discretion on scoring, assigning either the minimum or maximum score or some score in between the ranges.

An agency can use this evaluation tool in two different ways. The first is to conduct a high-level preliminary assessment. In doing this, the evaluator uses only those elements which are classified as high priority. The second is to use the complete tool for a more detailed assessment. Appendix C reassigns the elements of review to provide a two-tier approach to evaluating services or functions. The first tier includes several high level questions that should require little effort to answer; the second tier is more comprehensive with some questions requiring considerable effort to answer. One way to use the two tiers is to complete the first tier and if a sufficiently high score is determined, the evaluator should proceed with the second tier.

Once the assessment is completed, decisions on whether to pursue privatization can be made in two ways. First, if an agency is evaluating multiple services at the same time, then the total score can be used to rank-order all of the services being considered. In this case, the top quartile will generally be the services most prone to privatization. Second, if evaluating a single service, then a score of at least 65% of the total is a reasonable cutoff. Assessments scoring above that range are more likely to be successfully privatized.

Completion of the second tier questions will necessitate some cost analysis; the next section outlines basic steps necessary to conduct that analysis.

CONDUCTING THE COST ANALYSIS

This section presents the basic steps necessary to:

1. Develop the costs of providing services through the state,

2. Determine ways to capture the full costs associated with any state-provided services, and

3. Eliminate unfair cost comparisons that would give a state agency an advantage over a private vendor.

In preparing this cost analysis, unique situations may arise. Therefore, the following discussion of the approaches to use in conducting specific cost analyses has been provided for illustration purposes. The specifics of each privatization option may require revisions to the analytical approaches described here, requiring more or less detail in the determination of costs. The sample spread sheets may also need to be revised to fit the circumstances of any privatization option being considered. In previous sections we identified the need to allow State analysts to maintain flexibility to provide the analyses most suited for any particular privatization option. For that reason, we have also included a short description of an alternative approach to full cost analysis, later in this section.

The steps in the cost analysis begin with determining the full costs of having the State provide services and these steps must also be compliant with legislation (UCA 63I-4a-205) that requires "the Board by rule…[to] establish an accounting method that:

(1) is similar to generally accepted accounting principles used by a private enterprise;
(2) allows an agency to identify total costs of engaging in a commercial activity in a manner similar to how a private enterprise identifies the total actual cost to the private enterprise…;
(3) provides a process to estimate taxes an agency would pay related to engaging in a commercial activity if the agency were required to pay federal, state, and local taxes to the same extent as a private enterprise engaging in the commercial activity."

Per UCA 63I-4a-205, this method must consider all relevant labor expenses (such as compensation and benefits, and costs for training, overtime, supervision, and other costs), operating costs (such as vehicles and equipment, marketing, advertising, sales, accounting, and insurance, real estate, debt service, overhead, costs of capital, contract management costs; and any other relevant costs.

The following steps are designed to meet the requirements of UCA 63I-4a-205 as well as the usual methods for complete service costing. The worksheets at the end of this section include some general calculations that must be completed to provide a comprehensive cost analysis. The forms are intended to estimate the expected decrease or increase in the cost of providing any service to be privatized. This includes an assessment of the impact on state revenues. In many cases, longer-term costs may need to be calculated to give a fair comparison between the government-provided service and the privately-provided service. This generally requires a 3-5 year view to ensure the cost estimates are unduly influenced by transition costs.

The forms contain factors used in determining the annual cost of providing a given service. The cost analysis results in an annual estimate of the expected decrease or increase in the cost should the service be privatized. This includes an assessment of the impact on state revenues. In most cases, longer-term costs (3 to 5 years) should also be calculated. The analysis can be based either on actual expenditures or budgeted expenditures/estimated (in the case of longer term cost estimates).

As soon as the initial assessments have been done to illustrate the overall possibility of privatizing a service, the cost analysis can also begin. Cost analysis is usually service-based, because the overall privatization of an entire department or budget unit is less likely than the privatization of specific services offered within a department. In testing this cost analysis approach, State agencies have found that the level of analysis can vary significantly. In some cases, costs must be determined down to a very low level of the organization; therefore, the State's analysts need to understand that they may have to adapt their analyses to the lowest level of the agency being considered for privatization.

In completing this cost analysis, the analyst should carefully document all assumptions used to develop estimates. This step is important to the continued analysis of State-provided services, as well as to assisting any vendor in responding appropriately. For example, the analyst can assist the procurement staff in determining which costs and services should be included in any potential privatization procurement, and which costs and services are excluded from the procurement.

To conduct the cost analysis, the following steps need to be undertaken (Note: References to objects and their names are based on the State of Utah FINET system):

1. **Identify and clearly define specific services (or you may think of them as activities) that might be candidates for privatization analysis.**

    Services can be defined as a set of activities which are individually identifiable based upon the work performed by employees. This service also results in actions that benefit a specific set of customers, undertaken by specified employees. We refer you to the salary and wage worksheet included on page 24 (Worksheet 2, titled Salary and Wage Analysis). As you can see from the example the service being analyzed is the maintenance of light duty vehicles. For this service we have identified the staff involved in providing the various activities identified as part of this service. Presumably, the person undertaking this cost analysis will interview the staff involved in providing the service to determine the work they perform; these interviews assist in determining the activities that make up this service. At the end of this undertaking, you will have a set of salary costs by activity, including administrative/supervisory activities. A clear service definition can also assist in developing procurement documents.

2. Assign benefit costs to the salaries and wages determined for each activity or service.

If any other labor costs, not identified within the cost of engaging in the activity or service, are known (e.g., specific benefits assigned to specific employees) those costs can also be included in the labor expenses. In order to complete this task, all costs associated with Object AA--Personnel Services must be reviewed for inclusion of any of these costs in the costs of the service(s) being considered. It may be that the most appropriate means for assigning these costs is either an equal assignment or an assignment based upon salaries. The cost analyst must determine the most appropriate approach for assigning benefits to the salary and wage costs assigned to each activity/service. In some cases, departments have predetermined hourly rates, already burdened with appropriate benefits and those rates can be used.

3. Assign supplies and other operating costs to each activity or service.

These costs could be office supplies or other supplies related to the specifics of the work performed within each activity/service. For example, there might be contracts for specific kinds of repairs, as well as for tires, that can be considered a part of the cost of tire repair. There may be a need to conduct specific analyses of the details of expenditures within BB--Travel In State; CC--Travel Out of State; and DD--Current Expenses. The detail needed for these analyses will depend upon the size and complexity of the expenditures. It is possible that some expenditures (such as contracted services) may become activities, even if no staff are assigned. Office supplies may simply be allocated to all staff assigned to activities, based upon FTE count, if the expenditure is minor. In some cases specific contractual expenditures benefit specific services or activities very differently. In some cases, a service or activity may be contracted and no State employee salary and wage costs are identified.

4. Analyze EE-Data Processing Current Expenses for their impact on each service or activity.

Some data processing expenses may support most or all activities, such as work order system costs. Others expenses, such as specific software or consulting may benefit services or activities differently and should be analyzed in detail to determine which service or activity benefits from each expense.

5. Analyze Internal Service Fund (ISF) Charges.

During a test of these costing approaches, agencies have mentioned difficulties with assigning internal service fund (ISF) charges to services being considered for privatization. There is no single way to ensure that ISF costs are handled appropriately; however, since ISF charges are generally directly billed to a department, the total department billing from each ISF should be known. A review of the methods established for billing ISF charges may show the best way to deal with each ISF cost. For example, if billings from Human Resources are based upon FTE's the same approach can be used to assign Human Resource charges to each service or activity being analyzed. In some cases, such as determining the percentage of Information Technology services that should be assigned to a service or activity, the level of information technology support must be estimated. For example, some service support may be based upon the number of work orders processed through the work order system and a percentage of the total work orders can be identified as supporting the service or activity being costed. In many cases, the percentage of support for each service or activity is not enough to allow any reduction in the overall cost, which may be fixed across a specific set of information requirements. Thus, the cost analyst should use a practical approach to determining how to handle internal service fund charges. The analyst should not be expected to conduct an extremely detailed review of these costs, unless they compose a large percentage of the costs of providing the service or activity; reasonable estimates of service costs based upon expenditures, FTE's, work orders, etc., can generally substitute for detailed review of these billed costs.

6. **Review FF-Data Processing Capital Costs and GG-Capital Expenditures for impact on the costs of each service or activity.**

   At this time, it would also be appropriate to obtain a list of all current assets assigned to each service or activity and determine how those assets are to be treated, based upon the anticipated privatization. For example, can assets be sold to the private vendor? Or can the assets be sold or leased to another party to result in a net revenue increase? Or, do assets need to be depreciated or amortized? Are assets owned by the State or were they purchased with federal funds. Thus, will the assets need to be returned to the federal government or will residual value need to be repaid to the federal government? Are there ways to use the assets to avoid other expenditures (e.g., transfer laptops to other organizational units to avoid purchasing new laptops for that organizational unit)?

7. **Review HH-Other Charges/Pass-Through costs to determine whether and how they would be impacted by any privatization.**

   For example, cooperative agreements covered in these costs might not be included in the privatization.

8. **Determine indirect and administrative/support costs.**

   Data for this analysis may come from several sources. For example, costs allocated to departments through the statewide cost allocation plan need to be addressed to determine whether these costs are fixed (i.e., would remain whether a service was privatized or not) or variable (i.e. varies according to the services being included in state-provided services. For example, the budget office might not reduce staffing because one service is privatized, but if several services are privatized, including many State employees, there might be reductions in the staff assigned to process payroll transactions. Thus, part of this analysis will begin with reviewing costs allocated through the cost plan to determine whether these costs are truly impacted by the privatization.

Note: building costs can be covered within the statewide cost allocation plan or in the determination of assets assigned to services/activities. Debt service will be managed in compliance with State Treasurer processes.

9. Calculate the potential impact of privatization upon the need for administrative and supervisory support within the agency which oversees the service or activity being privatized.

If a very large service area (large portion of expenditure/FTE's), is involved, there may be some impacts elsewhere in the organization unit which oversees the activity or service being considered for privatization. For example, if staff involved in the current service would no longer be reporting to the organizational unit, but that unit is responsible for monitoring the contracted service, consideration has to be given to the appropriate staffing of that organizational unit. Although there may be a need for additional contract development and monitoring, would that work be assigned to the staff now involved in supervision and administration, or to other staff?

10. Assess current insurance and other risk mitigation costs.

Determine whether insurance or other liability is reduced or increased by privatization. There is no specific way to approach this issue other than to review specific insurances and determine the impact of privatization on insurance coverages or on other mitigating factors. If fewer staff are covered by current liability insurance, will rates decrease or increase due to privatization? Will the State be able to move liability to a vendor? (Also see Step 5 above, relating to internal service fund charges). Note that insurances included in internal service fund charges need to be assessed; however, other risk assessments may need to be conducted for each privatization option.

11. Consider both short-term and long-term costs.

For example, in the first year (years, if spread over more than one year) there will be potential employee lay-off costs. These costs may not continue into the future. Similarly, a vendor responsible for acquiring equipment and facilities may have some immediate costs that could be higher in short term. Or, if the State provides equipment or facilities to the vendor, long term costs may grow. If, however, the State can avoid certain pending costs by privatization, that will be an important consideration. In most cases 3 to 5 years costs should be assessed to mitigate transition and start-up costs.

12. Analyze costs to determine whether each cost is fixed or variable during the term of the analysis.

If, for example, the State were to have a higher level of supervision, should that level be included in the procurement requirements, or should the vendor be encouraged to provide alternatives? How will fixed costs be handled so as to allow the vendor to provide work methods and structures that may be more efficient? Thus, the evaluation of privatized options must be fair and competitive and consideration of fixed costs is important to this approach. Depending upon the scope of the cost analysis, it should be noted that all costs are variable over some time frame. Thus, the longer the potential time frame for privatized services or activities, the greater the possibility of reducing fixed costs associated with those services or activities.

13. Address revenue impacts.

In nearly all cases there will be taxes and fees paid by the privatized vendor that are not paid by the state when providing the services. Obviously, this could result in additional revenues to the State. The calculation of additional revenues will be based on legislative requirements for each type of business. There could also be some loss in revenues; for example, the federal government assists with some kinds of construction (e.g., water/sewer facilities) and private vendors may not be eligible for this assistance. In addition, some charges and fees previously resulting from a service might be collected by the vendor and no longer available to the State.

14. Carefully assess the potential costs associated with developing and monitoring any privatization strategy.

This assessment might include considering the training of purchasing and administrative staff, as well as of legal staff. There will be short-term and long-term costs associated with the development of staff skills necessary to effectively manage privatized services and activities. Then, staff time will need to be assigned to developing and monitoring contracted performance, etc.

15. Before concluding any cost analysis, identify and document all assumptions used in defining services and in developing cost analyses. This information will be required to determine the approaches to be used in procuring private vendor offers.

In addition to determining the costs associated with state service delivery, the same types of costs need to be addressed for each privatization option, as appropriate. In addition, the costs of developing and monitoring each method of privatized service delivery need to be addressed. The difficulty of contract development and monitoring can vary significantly among privatized options. Having a defined approach to costing services being considered for privatization will assist state staff in determining the documentation of costs from the vendors.

The following tables represent samples of the calculations associated with the cost analysis process:

Worksheet 1 **State of Utah** **Free Market Protection and Privatization Board** **Summary of Cost Assessment** Generally Accepted Accounting Principles (GAAP)		
	Cost of Engaging in Commercial Activity	$ 564,000.00
	Costs of Privatization	1,000,500.00
	Costs of Moving to Privatized Service (Year 1)	**$ (436,500.00)**

Work Sheet 2
State of Utah
Free Market Protection and Privatization Board
Salary and Wage Analysis

Generally Accepted Accounting Principles (GAAP)

Name/Position	Salary	Admin		Supervision		Paint		Body Work		Regular Preventive Maintenance		Tires		Oil Changes	
		%	$	%	$	%	$	%	$	%	$	%	$	%	$
Director	$ 100,000	50%	$50,000	50%	$50,000		$ -		$ -		$ -		$ -		$ -
Admin Supv.	$ 45,000	100%	$45,000		$ -		$ -		$ -		$ -		$ -		$ -
Mechanic I	$ 35,000		$ -		$ -	100%	$35,000		$ -		$ -		$ -		$ -
Mechanic I	$ 35,000		$ -		$ -		$ -	100%	$35,000		$ -		$ -		$ -
Mechanic I	$ 34,000		$ -		$ -		$ -	100%	$34,000		$ -		$ -		$ -
Mechanic II	$ 38,000		$ -		$ -		$ -		$ -	100%	$38,000		$ -		$ -
Mechanic II	$ 38,000		$ -		$ -		$ -		$ -		$ -	100%	$38,000		$ -
Mechanic II	$ 39,000		$ -		$ -		$ -		$ -		$ -		$ -	100%	$ 39,000
Totals	**$ 364,000**	**26.1%**		**13.7%**		**9.6%**		**18.9%**		**10.4%**		**10.4%**		**10.7%**	
			$95,000		**$50,000**		**$35,000**		**$69,000**		**$38,000**		**$38,000**		**$ 39,000**

Work Sheet 3
State of Utah
Free Market Protection and Privatization Board
Cost of Engaging in Commercial Activity
Generally Accepted Accounting Principles (GAAP)

		Amount
	Labor Expense	
	Salaries & Wages of Department Personnel (a)	$ 364,000.00
	Fringe Benefits	
	Other	
	Total Labor Expense	**$ 364,000.00**
	Other Operating Expense	
	Service and Supplies: Operating Costs (Fuel & Maintenance)	$ 50,000.00
	Equipment (Capital outlay)	
	Equipment (Interest Costs)	
	Depreciation	
	Operation and Maintenance of Buildings	
	Cost of Premiums Paid for Liability and Fire Insurance or Claims Paid in a Self-Insurance Program	
	Allocated Administrative Costs	
	Allocated Overhead Cost of Other Executive and Staff Agencies	150,000.00
	Management, Supervision, Oversight (similar to contract oversight	
	Other	
	Total Other Operating Expense	**$ 200,000.00**
	Total Cost of Engaging in Commercial Activity	**$ 564,000.00**
	(a) Includes supervisors, staff, and overtime of services provided as a direct cost to the activity. Time spent in training of these personnel are also included here.	

Work Sheet 4
State of Utah
Free Market Protection and Privatization Board
Cost of Privatization
Generally Accepted Accounting Principles (GAAP)

		Amount
	Start Up Costs	
	Request for Proposal - Development & Implementation	$ 10,000.00
	Contract Development	
	Bid Preparation	
	Bid Selection	
	Contract Monitoring Development System	
	Unemployment Benefits Liability for Displaced Workers	
	Leave Benefits Buy-Out, Severance Pay, and Accrued Liabilities for Displaced Workers.	230,000.00
	Disposing of Unused Equipment Write-Off Depreciation, Under Utilization of Space	
	Gain (Loss) on Disposition of Equipment, Under Utilization of Space	
	Transition Costs Such as Duplication of Effort	
	Other	
	Total Start Up Costs	**$ 240,000.00**
	Primary Contracting Costs	
	Contract Price (Annual)	$ 750,000.00
	Allowance for Cost over-Runs (Annual)	
	Effect on State Revenues (Will the State Stop Collecting User Fees?)	(61,500.00)
	Estimated Cost of the State Losing any Grants or Subsidies	
	Other	10,000.00
	Total Primary Contracting Costs	**$ 698,500.00**
	Contract Oversight Costs	
	Salaries	$ 50,000.00
	Fringe Benefits	12,000.00
	Service and Supplies	
	Equipment (Capital Outlay)	
	Equipment (Interest Cost)	
	General Operating Costs	
	Operation and Maintenance of Buildings	
	Other	

Work Sheet 4
State of Utah
Free Market Protection and Privatization Board
Cost of Privatization
Generally Accepted Accounting Principles (GAAP)

		Amount
	Total Contract Oversight Costs	**$ 62,000.00**
	Contract Support Costs	
	Space Provided	
	Equipment Provided	
	Other	
	Total Contract Support Costs	**$ -**
	Total Costs of Privatization	**$ 1,000,500.00**

Work Sheet 5
State of Utah
Free Market Protection and Privatization Board
Cost of Engaging in Commercial Activity
Salary and Wage Analysis
Generally Accepted Accounting Principles (GAAP)

		Amount
	Salary & Wages	
	Administration (a)	$ 95,000.00
	Supervision(a)	50,000.00
	Paint	35,000.00
	Body Work	69,000.00
	Regular Preventive Maintenance	38,000.00
	Tires	38,000.00
	Oil Changes	39,000.00
	Other	
	Total Salary & Wages	**$ 364,000.00**
	(a) Need to allocate to other activities	

Work Sheet 6
State of Utah
Free Market Protection and Privatization Board
Cost of Privatization
Effects on State Revenues
Generally Accepted Accounting Principles (GAAP)

		Amount
	IF Services NOT PRIVATIZED	
	Business Licenses	$ (10,000.00)
	Small Business Taxes	(7,500.00)
	Individual Employee Taxes	
	Property Taxes	(44,000.00)
	Business Income Taxes	
	Other	
	Total Effects on State Revenues	**$ (61,500.00)**
	If the State were to continue providing services with government employees or facilities, this would be an annual increase in revenues, if privatized.	
	Will current federal revenue continue after privatization)?	
	What will happen to charges or fees currently collected by State?	

Alternative Accounting Methods

The previous, very detailed accounting and cost determination methods identified in this manual assume that the costs of a specific service being considered for privatization are known or can be developed without an excessive amount of work. They also assume that the steps can be used to develop detailed costing, based upon the State's current budget/financial reporting structure. On occasion, however, the service being analyzed may not fit the State's reporting structure. For example:

1. Some state agencies do not use the usual state budget/financial reporting structure;

2. A state agency could object to undergoing the detailed cost analysis or may not be able to provide the information required to prepare the detailed cost analysis; or,
3. The service being analyzed may be new and there may not be enough information to undertake such a detailed analysis.

When such difficulties arise, simplified accounting methods may allow the continued service review. It should be noted that simplified methods may ignore the very issues that constitute the potential savings for some forms of privatization. Therefore, State analysts need to use caution when deciding to undertake simplified methods.

One such simplified method is referred to as ***throughput accounting***. This is a cash focused approach that does not calculate full costs. It ignores variable and fixed costs and overhead. In general, the private sector uses this technique to identify ways to maximize profits. Throughput accounting (TA) also does not rely on GAAP, which is included in the legislative requirements of UCA 63I-4a-205 for privatization projects. In the private sector, TA focuses on the goal of profitability. Thus, it will require a bit of analysis for a governmental service analysis that would need to look for other measures, such as efficiency (cost per unit).

There is a general feeling among proponents of TA that cost accounting focuses on costing all elements of a system, process, or service when management accounting should focus on identifying the roadblocks which limit an organization's ability to improve profitability. Thus, TA focuses more on ways to improve operations, through a simpler method of accounting.

Also, it is important to note that cost accounting focuses on the costs of labor, often with the goal of reducing labor costs. Since labor costs are the largest expenditures for most government services, cost accounting seems the appropriate method to use most of the time. Unlike cost accounting, throughput accounting focuses on profitability and may often ignore aspects of costs (labor and overhead) that are important to analyzing the impacts of privatization.

The purpose of developing the privatization manual has been to develop a disciplined approach to analyzing all aspects of a service to determine whether the State even wishes to continue the service. TA may not be the most comprehensive method for analyzing all of the elements identified in the privatization manual. However, it is another tool in the State analyst's toolkit and may be appropriate for analyzing services in some circumstances.

Steps in Throughput Accounting (TA)

The usual steps in throughput accounting can be summarized in the following equations:

- Throughput = sales revenue – total variable cost
- Throughput accounting ratio = return per factory hour/cost per factory hour

In general, throughput has been applied more to manufacturing processes, with the goal of of increasing net profit, by illustrating the contribution of various resource to overall profitability.

Other important equations in throughput accounting include:

- Net profit (NP)= throughput-operating expense (T-OE)
- Return on investment (ROI) = net profit/investment (NP/I)
- TA Productivity = throughput/operating expense (T/OE)
- Investment turns (IT) = throughput/investment (T/I)

Based upon this summary information, it would appear that throughput accounting might be a reasonable way to estimate performance improvements possible with increased productivity.

Advantages of TA

The advantages of TA include:

- Focusing on a smaller set of financial elements may make the use of TA a simpler approach in some very specific situations (see some examples of specific situations identified in the introduction to this section).
- Using TA may be a way to more easily illustrate potential improvements, utilizing appropriate definitions of desired output that do not necessarily relate to profit, expected from privatization.
- TA does appear to be flexible enough to allow redefinitions that provide appropriate definitions of the roadblocks and constraints that limit desired outcomes, moving from profitability to other desired outcomes.
- The greatest value of TA may be its identification of roadblocks which prevent the greatest effectiveness of an overall organization. Privatization does not always focus on an overall organization, but may focus on a very specific and defined service.

Disadvantages of TA

The disadvantages of TA include:

- TA focuses on a single goal—what set of processes will result in the greatest output. That output is generally assumed to be sales, revenue, or profit. These are not always the issues of greatest concern to governments; therefore, a governmental analyst or accountant may have even more difficulty adjusting data analysis to fit within the overall approach of traditional TA.

- The State's approach to privatization is not to analyze services to make the government provision of these services more efficient or effective; rather, the State believes there is often an inherent need to move from state service delivery. Therefore, TA may actually focus on issues which seem extraneous to the State's overall concerns about privatizing services, instead of improving the State's provision of those services.

- TA does not address the issues identified by the legislature identified in UCA 63I-4a-205--the legislatively preferred approach to accounting for privatized services.

- TA is not compliant with GAAP or with Federal rules and regulations; therefore, its use may create some problems in dealing with stakeholders often involved in reviewing state accounting methods.

PERFORMANCE CONTRACTING

The success of any alternative service delivery strategy depends heavily on how well the public agency manages the contractor. The heart of contract management is assurance that the agency is receiving what it needs, getting what it is paying for, and knows that the work is being performed at the desired level of quality, effectiveness, and efficiency. The key to accomplishing this standard is the use of performance contracting. This is a concept in which the agency bids work using a pre-established, quantifiable standard of contractor performance and employing regular reporting schedules.

Introduction to Performance Contracting

In 1998, the Office of Federal Procurement Policy (OFPP), the federal Office of Management and Budget (OMB) and the Executive Office of the President issued *A Guide to Best Practices for Performance-Based Service Contracts*. The Guide defines performance contracting as:

> "*Performance-based service contracting (PBSC) emphasizes that all aspects of an acquisition be structured around the purpose of the work to be performed as opposed to the manner in which the work is to be performed or broad, imprecise statements of work which preclude an objective assessment of contractor performance. It is designed to ensure that contractors are given freedom to determine how to meet the Government's performance objectives, that appropriate performance quality levels are achieved, and that payment is made only for services that meet these levels." (From on-line version of Guide—page numbers not available).*

In this section of the manual, we present how a State agency can structure a performance contract to assure the effective and efficient delivery of public services through alternative providers.

As pressure grows on government to use limited resources more productively, the State of Utah is placing greater emphasis on measuring and evaluating performance. This, for example, is the underlying driver for the State's current Operational Excellence initiative (SUCCESS).

An important element of this drive to performance management is the use of alternative service methodologies, particularly contracting services to private business, not-for-profit organizations, and other public entities. Historically, there has been a broad assumption that such alternative approaches provide more efficient and effective services. As a result of this assumption, most public contracts have usually included only limited performance standards. Most of the contracts use only broad language about compliance with applicable law or regulations. About the only exception has been the use of numeric standards when required by regulatory agencies, such as standards of treatment for child care, environmental standards for waste management, and engineering and construction standards for highways and buildings.

While increasingly common in the private sector, governments have only rarely used performance incentives or penalties.

In the public sector, the federal government, particularly the Department of Defense and the General Services Administration, have taken the lead in using performance contracting. Both DOD and GSA have issued documents on the development and use of performance contracting that provide detailed work steps for performance contracting in the federal sector. Despite legislation adopted as early as 1998 emphasizing performance contracting in the federal government, this approach is still more the exception than the rule.

Nonetheless, state and local governments lag well behind the federal government. During the course of the development of this manual, project staff routinely surveyed various public bid sites to find requests for proposal that purposed to be based on performance contracting. None of the some fifty RFPs that were reviewed came close to the standards recommended in the federal instructional material. Construction RFPs came the closest, mainly because they used specific engineering standards and had field inspection elements that are uncommon in non-construction projects. Project staff observed the following typical flaws:

- Scopes of work that were not sufficiently specific or well presented;
- Heavy reliance on non-quantitative standards of performance;
- Absence of meaningful performance measures;
- Excessive detail on how to perform work, relying on the detail as a measure of performance;
- Absence of procedures for formal inspection and acceptance of work; and,
- Lack of incentives or penalties.

The reason we are focusing on performance contracting is that it has proven to be very effective at producing better output at lower cost in both the private and public sectors, when used appropriately. However, its use is spotty and not often reported as it is not a new concept. It is a useful one because, as was discussed during the development of the manual, the reason privatization often does not work includes analysis of the feasibility on the front-end and implementation and monitoring on the back end. Performance contracting focuses on output and requires careful development of performance-related work requirements, as well as monitoring of performance. Thus, it supports effective implementation and monitoring—two keys to successful privatization.

Essential Steps in Performance Contracting

The following are the essential steps that an agency should follow in developing a performance contract:

- Identify the service area to be contracted;
- Design a meaningful scope of work;
- Determine effective and efficient performance measures;
- Develop meaningful performance incentives and penalties; and,
- Identify necessary contract management.

These essential steps focus on development of the contract RFP, with the assumption that the RFP and the awarded proposal are included by reference in the final contract document.

1. Identify the service area to be contracted

The first step in performance contracting is understanding the services being contracted: this section will include using the approaches detailed in the privatization manual to define services and identify expected performance.

This work begins with definition of the service(s) being contracted. The preceding service costing sections of this manual describe how to identify services and evaluate the potential for service contracting.

In identifying potential service areas, it is important to remember to keep the service as narrowly defined as possible. This is a balancing act that relies on professional judgment. If the service is defined too narrowly, there is less likelihood of achieving desired cost savings because there is not sufficient mass of work to affect either base or per unit costs. If the service is defined too widely, it will make writing and managing a contract more difficult and has the potential for reducing the number of qualified bidders.

2. Design a meaningful scope of work

Almost without exception, the success or failure of a performance contract rests on the quality of the scope of work. Again, it is a balancing act. A scope that is too broad will result in confusion, difficulty in getting what the agency wants, ineffective enforcement, and compensation arguments. A scope that is too narrow will almost certainly omit key work activities and will be so constraining as to minimize the potential for cost savings.

The first step in preparing a scope of work is to walk through the service to be contracted and outline what needs to be done. Review the outline and remove any work activity that is optional or does not appear to add value to the service being delivered. Whatever is left is the appropriate scope of work. Write the scope outline in narrative form. To the extent possible, use simple sentences. The purpose is to have a document that clearly establishes the work to be performed without any confusion.

The second step is to remove all unnecessary work requirements. As noted, a common error in public contracting is to mistake work requirements for performance. For example, many forestry contracts include requirements for the types of chain saws to be used, how frequently the saws have to be cleaned, the type of cleaning solution to be used on the saws, the types of equipment to be used, and crew size. This is considered to be performance. But, it is not. Performance is the percentage of trees pruned according to industry standards for crown/ball relationship. It is important to remove these extraneous requirements for the following reasons:

- Remember that what the State is seeking as a cost-effective and efficient means for providing a public service. It is important to remove any requirements that do not contribute directly and measurably to performance;

- The more requirements a contractor must meet, the more you restrict the contractor from using creative solutions to cost reduction;

- If you apply in-process requirements such as those listed in the forestry example, the more requirement there is to have an inspector on-site at all times. This reduces the overall cost effectiveness of contracting the service. Sometimes, such as in construction contracts, it is necessary to have an inspector on-site; most of the time, however, onsite inspection should be minimized.

An effective method for testing the clarity of a scope of work is a pre-proposal conference with prospective vendors. Such a conference occurs prior to the issuance of a request for proposals. The purpose is to invite prospective vendors to an open meeting to discuss the draft scope of work and to identify potential improvements in the scope so that work and performance expectations are clearly and commonly understood. This type of conference eliminates a lot of post-RFP questions and confusion.

3. Determine performance measures

Having selected the scope of work, the next step is the assignment of performance measures to each task or outcome. The characteristics of, and the process for selecting, measures is the same in performance contracting as it is in an agency's internal performance reporting system.

There are six criteria for the selection of measures to be used in a performance contract. These include:

- Each measure needs to be relevant to the mission/objectives of the contract and to the outcome which it is supposed to help measure.

- The intent of a measure needs to be clearly understood. If there is a lack of agreement on the purpose of the measure, then there is a strong possibility that the measure will not adequately represent desired work performance.

- The measure needs to be important. It is a common axiom that people and organizations will direct their work according to the way they are measured. The selection of any measure makes that measure appear to be important, whether it is or not. If any agency selects measures that are not important to the overall performance of the contract, then it will get unimportant results.

- Measures should not duplicate or overlap each other. If they are duplicates, then the agency will not be using its resources effectively. If they overlap, it is possible that standards could be conflicting, resulting in ineffective contract administration and contractor disputes.

- The contractor needs to have direct influence or control over the outcomes. In order to reward or punish performance, an agency must be able to hold the contractor accountable for work performance. If work is strongly influenced by factors outside the contractor's control, it would be inappropriate to hold the contractor fully accountable .

- The cost of data collection and analysis must also be considered. A costly data collection system can negate much of the value of a performance contract. Additionally, if data collection, reporting, and analysis is highly burdensome on either the agency or the contractor, then the performance measurement system will collapse of its own weight and the value of the performance contract will be lost.

Each performance measure needs to meet certain standards. These include:

- The measure starts off with a numerical designation. This would be count of an item, data presented as a percentage, or similar numeric. All measures used in a performance contract must be specific and numeric. Any measures that do not meet this standard will result in confusion and less than effective contract monitoring.

- The wording of each measure must be specific so as to leave no question about what the measure means and whether or not the contractor meets the measure.

- The measure targets some important aspect of the outcome. A common error in any performance measurement system is the generation of a great number of measures in a shotgun approach. A more effective system relies on fewer measures—usually no more than three to five—carefully selected based on what is most important.

- The cumulative effect of the measures is that they cover all desired outcomes.

- The list of measures needs to cover all the "quality" characteristics or areas of concern to customers. In the case of performance contracts, there are two sets of customers. The first set is the management of the contracting agency. The second set is the citizens who receive the services provided by the contractor.

- The list of measures should include relevant feedback from customers of the program.

4. Develop meaningful performance incentives and penalties

Once the agency has identified the most appropriate performance measures for the contract, the next step is the establishment of the performance standards for threshold acceptance as well as performance incentives and penalties.

The threshold measure is that level of performance which triggers payment of the base contract amount. The agency will have identified this measure in the preceding work step. The question here is the range of acceptability. There are two bodies of thought about the acceptance range. One is that the threshold measure is the minimum level of performance that is acceptable. A second body of thought is that the threshold is a center point for acceptance. For example, acceptability may be within ten percentage points, plus or minus, of the threshold performance measure. This latter approach allows the agency more discretion in the management of the contract.

The decision on the amount of potential performance incentive is not arbitrary. First, the agency needs to determine the level of performance above the threshold that will trigger any bonus payment system. This range should represent a performance "stretch," that is, a level of performance that is achievable but not easily so. Secondly, the bonus should be scaled so that different levels of performance will yield increasing bonus payments. The purpose for the scaling is to encourage continued high performance, even after the bonus trigger has been met. Third, there needs to be a cap on the maximum bonus to be paid. This limits the payment liability of the agency and enables effective budgeting for the contract.

The maximum bonus payment needs to be a win-win for both the agency and the contractor. The bonus payment should be sufficient to encourage higher levels of performance. However, if it is too high, the agency runs the risk of incurring costs that exceed what the contracted service was originally costing. Thus, the incentive payment should split the difference between the original service cost and the threshold cost of the contract. For example, if the original cost were $200,000 and the threshold performance cost is $150,000, the $50,000 difference should be the maximum range for any incentive payment. If the agency were to cap the incentive to 20% of the net savings, then the maximum bonus would be $10,000. This provides an incentive to the contractor while the agency still achieves a net savings of $40,000. **To assure the ability**

to pay, the agency should encumber the full amount of the contract and any potential incentive payment.

To the extent possible, the performance penalty should mirror the incentive structure. There is an important condition, though, that must be considered. The penalty should be sufficient to encourage improved performance but not so severe as to cause the vendor to discontinue the contract. Any decision to terminate a contract should be made by the agency based on unacceptable performance. However, if the penalty substantially eliminates a vendor's profit on the contract, it is likely that the contractor may make a termination decision on its own. The balance point is that the penalty should encourage improved performance but should not eat into the vendor's direct operating costs.

The next decision to be made in determining incentives and penalties is how to apply the adjustment. There are two approaches. The first is to segment the contract into distinct tasks and award incentives or penalties based on each task. For example, a contract may have five tasks, with each task having three performance standards. The bonus would be divided among the five tasks based either on relative importance or cost. The contractor would have to exceed all of the performance measures for a given task to be eligible for a bonus payment or fail on all of the measures in order to be penalized. Each of the five tasks would stand alone so that, for example, a contractor might earn a bonus on two tasks, receive threshold payment on two tasks, and be penalized for one task.

The second approach to incentives and penalties is to lump all of the tasks together and award either a single bonus or penalty. For example, continuing to use the five task and three measures per task, if the contractor were to exceed performance standards for at least half of the fifteen measures and achieve threshold on the remaining measures, then the contractor might be eligible for lump-sum bonus. Similarly, failure to meet threshold on a majority of the measures would result in a penalty.

The remaining decision is the frequency of bonus and penalty assessment. The agency can chose to make payments on a quarterly, semi-annual, or annual basis. The advantages of mid-year strategies, such as quarterly or semi-annually, is to connect payments or penalties more closely to the performance period, to encourage continued high performance, or to generate prompt corrective action.

These are all decisions that the agency can make before issuing the request for proposal. If so, then this system should be clearly explained in the RFP document. An alternative approach is to describe the system in general in the RFP and afford prospective vendors the option of describing their recommendations for implementation.

5. Identify necessary contract management

There are three elements to the effective management of a performance contract. These include creation of a system of on-going contract management, preparation of a scope document to be included in the RFP and subsequent contract, and regular reporting on contractor performance.

The agency needs to establish a contract management unit in advance of issuing an RFP for privatized services. [And the privatization analysis described in this document requires an analysis of the costs of managing a contract.] Depending on the number and size of contracts, the agency's contract management might consist of only one professional contract manager or it may include several contract managers supervised by a contract administrator. Also, the contract may also necessitate field inspectors. Inspectors can either be part of the contract management unit or based inside the operating units of the agency. Contract management is not a part-time job. The contract administrator and managers need to be assigned full time.

The duties of the contract management unit include:

- Working with the agency's user division, develop the scope of work and performance standards to be applied and prepare the RFP/contract scope of work template;
- Conduct the on-going review of contractor performance through the life of the contract; and,
- Prepare, disseminate, and report a monthly contract performance report.

Scope of Work Template

The scope of work template is a table that lists:

- Each part of the desired scope of work;
- Performance thresholds for each scope item, including performance incentives and penalties; and,
- A description of how the client agency will formally accept each scope work item.

The Department of Defense and General Services Administration has developed a model template that it recommends for federal agencies. The template is in the public domain and is available to anyone who wishes to use it. That template is modified here to reflect more accurately the recommendations in this manual. A sample of the suggested template is on the following page:

TASK: MAINTENANCE OF HIGHWAY GUARD RAILS						
TASK DESCRIPTION: Replace highway guardrails in a timely fashion						
Work Step	**Objective**	**Measure**	**Performance Threshold** **(Sufficient for payment of base contract amount)**	**Incentive Performance** **(Payment of up to 5% over the base contract amount)**	**Penalty Performance** **(Payment reduction of up to 5% of the base contract amount)**	**Client Acceptance**
1	Install or replace critical-need rails as directed by contract administrator	• Percentage of critical rails installations started within established time frame after notification • Percentage of critical rails fully installed within established time frame	• Achieves measure for 85-90% of installation orders • Achieves measure for 90-95% of installation orders	• Achieves measure for 91% or more of installation orders • Achieves measure for 96% or more of installation orders	• Fails to achieve measure on more than 15% of the installation orders • Fails to achieve measure on more than 11% of the installation orders	• Field engineer review and approval of work in writing • Field engineer review and approval of work in writing
2	Install guard rails according to standards set by the State of Utah and as directed by contract administrator	• Percentage of installations that meet regulated standards and established time frame	• 80-90% of rails installed in compliance with established standards and time frame	• 91% or more of installations completed within established standards and time frame	• Less than 80% of installations completed within established standards and time frame	• Field engineer review and approval of work

On-Going Review

Once the contract is in place, the contract management unit is responsible for conducting regular performance reviews. These reviews consist of two work elements. First, the reviews need to include regular field inspections. The nature and scope of the work will dictate how frequently field reviews need to be conducted. Field reviews can be conducted by either the contract management staff or any existing field inspection personnel. Field inspections should include both regularly scheduled reviews and random, unannounced reviews.

The second part of the review process is the collection and review of all contract documentation. This includes review of all contractor reports, inspection reports, invoicing, exception reports, change order requests, and client feedback.

Monthly Status Reporting

Regular reporting is an essential part of any performance system. Performance contracting is no different. There are several reasons why frequent, public reporting is valuable:

- Publicly reported performance emphasizes the importance of the work being performed;
- It establishes public credibility for any incentive or punitive action; and,
- It provides advance notice of any potential performance issues. The earlier the agency and contractor identify an issue, the more time there is to correct the problem.

The reporting does not need to be highly complicated. In fact, the most effective approach to performance reporting is a "dashboard" report, that is, a report which presents only the highlights so that managers, policy officials, and the public can quickly see how well a contractor is performing.

The table on the following page is a Stoplight Dashboard. Rather than reporting detailed numbers, this dashboard simply presents each performance activity using stoplight colors. An activity identified as **Green** means that the work is being performed at threshold or better levels**.** **Yellow** means that the performance is slightly below the threshold but that prompt corrective action can reestablish threshold performance. **Red** means that the performance is well below the threshold requirement, to the point that the contractor may have difficulty meeting that threshold by the end of the annual contract period. This dashboard captures both monthly performance and quarterly trends. This enables the contract manager to monitor both short-term and intermediate term performance.

SAMPLE MONTHLY CONTRACTOR PERFORMANCE REPORT							
Work Activity	**Performance Measure**	**Performance Standard**			**Actual Performance**		
		Threshold	**Bonus**	**Penalty**	**Current**	**3-Month Trend**	**Explanation and Corrective Plan**
					G/Y/R	G/Y/R	

The contract manager should not prepare this report in isolation from the contractor. Rather, once the contract manager has assembled the report, the manager should meet with the contractor to review the report. Where performance is reported as either yellow or red, the contractor should have the opportunity to prepare an explanation for the performance and a correction plan to eliminate the performance deficiency.

In Conclusion

This section provides an overview of performance contracting and the principal steps that need to be followed. This section is to be considered a template that any agency can use. There are many different options that an agency can use, and we have designed this template to allow for maximum flexibility while creating a common structure.

Included as an appendix to this manual is a bibliography of literature providing additional detail on performance contracting. This bibliography includes published manuals, policies, procedures and best practices (DOD, Department of the Army, US General Services Agency, various State and local governments, and the Reason Foundation.

APPENDIX A: PRIMARY ALTERNATIVE SERVICE DELIVERY STRATEGIES

The following are the major alternative service delivery strategies available:

- **Contracting Out or Out-Sourcing**: this is a common strategy, which includes writing a contract with a private entity (for profit or non-profit) to provide a service or set of services previously provided by the State, usually using State employees.

- **Disposing of Unprofitable Government-Funded Activities**: this strategy is often referred to as shedding government owned companies (services that are operated as businesses, such as utilities or golf courses) or as making these companies more profitable.

- **Improving Efficiency, Quality, and Responsiveness of Services**: any activity that allows/encourages State staff or departments to improve services, particularly at reduced costs.

- **Leasing Equipment or Facilities**: this strategy allows the State to avoid major purchases when leasing is a less expensive option.

- **New/Expanded Use of Good Business Practices**: any activity that enhances State finances/revenues and reduces costs could be included in this strategy; for example, enhancing cash management and restructuring debt are usually considered examples of this strategy.

- **Providing Services with Volunteers**: this strategy is a form of public-private partnership which utilizes volunteers.

- **Public-Private Competition**: this strategy includes allowing State employees to compete with private entities (for profit or non-profit) to provide a service or set of services previously provided by the State. It is possible to have any private sector entity consider the hiring of State employees who previously provided the service, should a private sector entity "win" the competition.

- **Public-Private Partnership**: this strategy is a voluntary partnering between the State and any private sector partner to cooperatively provide a service or set of services. This strategy could include joint public-private financing and development of facilities and other infrastructure.

- **Removing or Reducing Regulations**: this strategy encourages private sector businesses to develop or expand by eliminating excessive State regulation of business.

- **Shedding Assets**: this strategy involves identifying capital assets which are either under-utilized, no longer necessary, or which have sufficient equity that sale or purchase-leaseback allows recovery of the equity and/or reduced operating costs. The most common uses of this strategy include fleet, public buildings, parking facilities and parks and recreation properties and facilities. Less common are assets relating to aviation facilities, toll highways and bridges, and public utilities.

- **Shedding Unnecessary Services**: this strategy is much like disposing of unprofitable government-funded activities; however, the focus is less on cost and more on the lack of use of a service of the lack of mission criticality of the service.

- **Social Impact Bonds:** this relatively new approach, also called" pay for success" or "social finance initiatives" uses private funding to advance new social service delivery models. Often philanthropic groups fund interventions delivered by non-profits on behalf of governments under a pay for success contract. Investors would receive payments from governments because outcomes are better and costs are lower.

- **Use of Vouchers for Clients to Purchase Services from the Private Sector**: this strategy allows the State to issue vouchers as a way to avoid providing the service or set of services and to utilize services already available in the market place.

- **Using Assets to Increase Revenues**: this strategy usually includes working with a private sector partner to develop additional uses for assets that assist in increasing revenues to the State. Another aspect of this strategy would be working with a private sector partner to develop methods for gaining additional uses for any excess capacity related to facilities or other assets. A State agency could also provide ways to utilize assets and excess capacity to increase State revenues.

APPENDIX B: PRIORITY SCORING OF PRIVATIZATION EVALUATION ELEMENTS

Following development of the privatization evaluation instrument, the Privatization Process Advisory Committee prioritized the various criteria. They used a high-medium-low scoring scale. Each member of the Committee assigned 9 points to high priority elements, 3 points to medium priority elements, and 1 point to low priority elements. The following scoring table has been developed for use in completing the review indicated above.

	COMMITTEE RANK SCORING	**PRIORITY GROUP**	**MAXIMUM SCORING RANGE**	
			Yes	**No**
GENERAL ELEMENTS				
GE 1: Is the service being reviewed considered a mission critical service of Utah State Government?	22	Very Low	0	5
GE 2: Do other alternatives exist for providing the service?	63	High	25	0
GE 3: Could the State replace a provider if costs or performance proved unsatisfactory?	37	Medium	15	0
GE 4: Is there a significant level of political opposition to privatization of this service?	23	Low	0	20
GE 5: Has this service been successfully privatized by other state or local governments? By the Federal government?	35	Medium	15	0
GE 6: Are there any known legal barriers to privatization?	63	High	0	25
GE 7: Are there any obvious risks to be considered with the privatization of this service?	57	High	0	25
GE 8: Does a vendor need access to	21	Very Low	0	5

	COMMITTEE RANK SCORING	PRIORITY GROUP	MAXIMUM SCORING RANGE	
			Yes	No
confidential information?				
PERFORMANCE ELEMENTS				
PE 1: Does this service currently utilize quantifiable and measureable performance measures?	35	Medium	15	0
PE 2: Would it be difficult to assess the performance of the privatized service?	39	Medium	0	15
PE 3: Would there be a high level of risk if a privatized service did not meet required performance requirements?	57	High	0	25
PE 4: Would the State be able to transfer liability to a service vendor in the case of poor performance?	31	Medium	15	0
PE 5: Would the State be able to reward or penalize any vendor or performance?	39	Medium	15	0
PE 6: Would it be difficult to construct a performance contract for this service?	29	Medium	0	15
COST ELEMENTS				
CE 1: Do the current costs for providing this service appear high?	57	High	25	0
CE 2: Does the percentage of fixed current costs appear to exceed 50%?	43	Medium High	0	20
CE 2: Does the percentage of variable current costs appear to exceed 50%?	43	Medium High	20	0

	COMMITTEE RANK SCORING	PRIORITY GROUP	MAXIMUM SCORING RANGE	
			Yes	**No**
CE 4: Does State service cost appear to be higher than privatized costs?	57	High	25	0
CE 5: Would it be difficult to monitor service costs for a privatized service?	48	Medium High	0	20
CE 6: Are the estimated costs of contract development appear to exceed 15% of the estimated annual savings?	23	Low	0	10
CE 7: Are the estimated annual costs of contract monitoring less than 15% of the estimated annual cost savings?	29	Medium	15	0
CE 8: Would privatization have a positive impact on tax revenue?	23	Low	10	0
CE 9: Are other State departments paying a part of this service?	29	Medium	0	15
CE 10: Is the estimated costs of employee lay-offs greater than 25% of the total cost savings if the service were to be privatized?	31	Medium	15	0
CE 11: Does the current State service have excess capacity that could be sold due to privatization arrangement?	21	Very Low	5	0
CE 12: Does the current State service operate any facilities that could be shed due to privatization?	25	Low	10	0
CE 13: Would staffing costs to be eliminated due to privatization be equal to or greater than the ratio of staffing costs to overall service costs?	45	Medium High	20	0
STAFFING ELEMENTS				

	COMMITTEE RANK SCORING	PRIORITY GROUP	MAXIMUM SCORING RANGE	
			Yes	**No**
SE 1: Are the potential impacts on State employees considered to be significant or out of proportion to potential gain from privatization?	37	Medium	0	15
SUMMARY				
Summary 1: How comfortable would you feel in privatizing this service?	28	Medium	15	0
Summary 2: Do you think service quality will improve? Or should improve?	51	Medium High	20	0
Summary 3: Do you think costs will decrease? Or should decrease?	45	Medium High	20	0
Summary 5: Are there other issues which cannot be scored by need to be considered?	24	Low	0	10
TOTAL MAXIMUM SCORE			525	

Priority Grouping	Committee Score	Evaluator Scoring Range
High	57+	0-25
Medium High	43-51	0-20
Medium	28-39	0-15
Low	23-25	0-10
Very Low	21-22	0-5

APPENDIX C: TIERED PRIVATIZATION EVALUATION

As noted in the text of this manual, the recommended approach to evaluating the potential for alternative service delivery strategies is the use of a two-tiered evaluation. The first tier is a relatively highly level, quickly performed assessment of key evaluation items. This allows the evaluators to determine quickly whether the potential is sufficient to engage in a more detailed analysis. The second tier of evaluation provides the vehicle for a more detailed analysis.

Commercial Activities Inventory Survey (Tier 1)					
			MAXIMUM SCORING RANGE		
Tier 1 Questions		**Responses**	**Yes**	**No**	**SCORE**
1	Describe the service/function so there is a clear understanding of the service and how it operates.				
2	What is the budget and/or actual cost for this service/function?				
3	Do other alternatives exist for providing the service?		25	0	
4	Are there any known legal barriers to privatization?		0	25	
5	Are there any obvious risks to be considered with the privatization of this service?		0	25	
6	Would there be a high level of risk if a privatized service did not meet required performance requirements?		0	25	
7	Has this service been successfully privatized by other state or local governments? By the Federal government?		15	0	

Commercial Activities Inventory Survey (Tier 1)					
			MAXIMUM SCORING RANGE		
Tier 1 Questions		**Responses**	**Yes**	**No**	**SCORE**
8	Does this service currently utilize quantifiable and measureable performance measures?		15	0	
9	Is the service being reviewed considered a mission critical service of Utah State Government?		0	5	
10	Does the current State service have excess capacity that could be sold due to a privatization arrangement?		5	0	
11	Does a vendor need access to confidential information?		0	5	
12	Is there a significant level of political opposition to privatization of this service?		0	20	
	TIER ONE	**SCORE**	**Maximum Score 165**		
While there is no set threshold score, generally a score that is equal to, or greater than, 65% of the maximum score indicates that an alternative service delivery strategy may be possible.					

Commercial Activities Inventory Survey (Tier 2)					
			MAXIMUM SCORING RANGE		
Tier 2 Questions		**Responses**	**Yes**	**No**	**SCORE**
1	Do the current costs for providing this service appear high?		25	0	
2	Does State service cost appear to be higher than privatized costs?		25	0	
3	Do you think service quality will improve? Or should improve?		20	0	
4	Would it be difficult to monitor service costs for a privatized service?		0	20	
5	Would staffing costs to be eliminated due to privatization be equal to or greater than the ratio of staffing costs to overall service costs?		20	0	
6	Do you think costs will decrease? Or should decrease?		20	0	
7	Does the percentage of fixed current costs appear to exceed 50%		0	20	
8	Does the percentage of variable current costs appear to exceed 50%		20	0	
9	Would it be difficult to assess the performance of the privatized service?		0	15	
10	Would the State be able to reward or penalize any vendor or performance?		15	0	
11	Could the State replace a provider if costs or performance proved unsatisfactory?		15	0	

Commercial Activities Inventory Survey (Tier 2)					
			MAXIMUM SCORING RANGE		
Tier 2 Questions		**Responses**	**Yes**	**No**	**SCORE**
12	Are the potential impacts on State employees considered to be significant or out of proportion to potential gain from privatization?		0	15	
13	Is the estimated costs of employee lay-offs greater than 25% of the total cost savings if the service were to be privatized?		15	0	
14	Would the State be able to transfer liability to a service vendor in the case of poor performance?		15	0	
15	Are the estimated annual costs of contract monitoring less than 15% of the estimated annual cost savings?		15	0	
16	Are other State departments paying a part of this service?		0	15	
17	Would it be difficult to construct a performance contract for this service?		0	15	
18	Are you comfortable privatizing this service?		15	0	
19	Does the current State service operate any facilities that could be shed due to privatization?		10	0	
20	Are there other issues which cannot be scored but need to be considered?		0	10	
21	Do the estimated costs of contract development appear to exceed 15% of the estimated annual savings?		0	10	
22	Would privatization have a positive impact on tax revenue?		10	0	

Commercial Activities Inventory Survey (Tier 2)					
			MAXIMUM SCORING RANGE		
Tier 2 Questions		**Responses**	**Yes**	**No**	**SCORE**
	TIER TWO	**SCORE**	**Maximum Score 360**		
	TIER ONE	**SCORE**	**Maximum Score 165**		
	SUM OF SCORES	**TIER ONE PLUS TIER TWO**	**525**		
While there is no set threshold score, generally a score that is equal to, or greater than, 65% of the maximum score indicates that an alternative service delivery strategy may be possible.					

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