

Officer responsible City Manager	Author Mike Richardson
Corporate Plan Output: Corporate Advice	

This report is prepared in response to the Council resolution of May “... *that the City Manager report to the Strategy and Resources Committee as soon as possible on the possible corporatisation of Works Operations, and on the reasonableness of the overhead costs borne by Works Operations*”.

SUMMARY

Works Operations has generally proved itself efficient and competitive in the period from 1989. It remains comparable with any contractor in town in terms of its overall levels of efficiency. It is, however, at the present time facing significant challenges. A shortage of civil engineering work in Canterbury is leading to prices at the present time being extremely sharp in the area of construction projects in which environment there is inevitably pressure on Works Operations workload. At the same time the unit has lost a small but significant number of major maintenance contracts, and while it is very efficient in these areas it is not realistic to anticipate that it will win 100% of such work if it is tendered. These factors together in recent months have led to both slimmer margins and contracting turnover.

As part of the Christchurch City Council, Works Operations must operate under the Local Government Act (not the Companies Act) and this precludes the unit from moving into other markets, particularly the wide range of private contracting work. Accounting policies have also meant that Works Operations surpluses have not been retained by the unit or used for investment and restructuring. While it is possible for the unit to “subsidise” one competitive job from another competitive job the unit is not able to carry a year-end profit on its competitive work as a whole to “tide it over lean times”.

There have been and are significant benefits to the Council through the existence of Works Operations (and its sister unit Plant and Building Services) but trends increasingly show that with the current “rules of the game” the units’ viability is becoming marginal.

The first six months of this calendar year saw a significant number of major maintenance contracts won by Works Operations with a small number of losses. The pattern of work for tender is such that workflow for the unit should now be relatively stable for the next 6-9 months.

A team of senior staff together with outside commercial assistance is working on alternative future directions for Works Operations with the objective of identifying a growth path for the unit. It is anticipated at this time that the outcome of this work will be brought to elected members next February. The scope of the work includes consideration of commercial options and also review of the extent to which there remain inherent benefits in maintaining an in-house Works Unit.

The announcement by Government of any intention to introduce legislation to alter the Council's responsibilities for the provision of infrastructure services would be relevant to the unit's future.

At the present time there is agreement both from Works Operations and Plant and Building Services on the one hand and from the Council Accounting Services Unit on the other that the allocation of overhead costs to Works Operations is fair and reasonable. Any changes that result from the current review exercise would of course lead to these being reviewed.

The rest of this report provides further background for the information of Councillors.

THE HISTORY OF WORKS OPERATIONS

The Works Operations Unit was formed at the time of local authority amalgamation, its official launch as a unit being 1 April 1990. It brought together, with some minor exceptions, all of the Council's field staff. This was done to help ensure separation between policy/asset management functions (in units such as City Streets and Waste Management) and service provider functions. The principle behind the establishment of the City Design Unit was similar.

The other significant "blue collar" unit established at the time was Plant and Building Services. This unit was set up as the owner and lessor of all Council mobile plant, together with associated mechanical workshops. Through the plant hire activity the Works Operations Unit and Plant and Building Services Unit are closely connected. Plant and Building Services is based at Milton Street which is also the main depot and office for Works Operations. The Building Services activity (principally decorators and carpenters with a smaller number of plumbers) employs tradespeople whose work has for several years been on a contractual basis, generally relatively small jobs principally related to the Council's housing stock.

Works Operations and Plant and Building Services have, since 1990, been treated as separate business units for accounting purposes. Full overheads are allocated on an agreed basis, market rentals are paid on all property, a return is required on capital employed and the appropriate depreciation regime is applied to all capital.

The object of this is to ensure that the costing of works represent the true costs of the output produced, taking into account all the normal business costs. A major review of Works Operations was undertaken in 1992 which confirmed that Works Operations was operating fairly as a separate business unit. Both internal audit and the Council's external auditors have continued to keep accounting of these units under review. The last three or four years have seen a series of healthy negotiations between the Works Operations Manager and Corporate Units such as Personnel and Accounting Services with the former seeking to ensure that he receives value for money in the services for which he is charged. These services are now provided to Works Operations and Plant and Building Services generally within the framework of service level agreements that spell out the level of service and the basis of charging.

As is the case with other Council units change within Works Operations has been ongoing. The number of Council depots has been reduced from 13 in early 1990 to 2 at the current time with further rationalisation considered on an ongoing basis. The internal structure of Works Operations was completely re-organised during 1997 to ensure a business team approach and the quest for improved procedures and efficiencies has been unrelenting.

WORK LOAD AND TENDERING

The value of work carried by Works Operations in 1997/98 was \$37.75 million. The proportion of this work that Works Operations performs on a contractual basis has steadily increased. At the time of amalgamation it was almost zero; by 1994/95 58% of work was carried out under contract; in 1996/97 this figure had risen to 65% and at the present time is around 75%. This 75% of contract works represents both jobs that went through tender procedures and also negotiated contracts.

Historically, the activities that were tendered first have been the construction ones as opposed to operational or maintenance areas of work. A significant exception to this was refuse collection that was tendered early on and re-tendered in conjunction with the introduction of kerbside recycling a few months ago. Construction work has been fully competitively tendered for several years for most of which period work flow has been reasonably steady for Works Operations. An important characteristic of construction work is that individual jobs are relatively small generally with a duration of days or weeks. The unit competes for a large number of such tenders over any period of time and records show that a success rate of about 30% of tenders submitted is achieved. Given the number of contractors in the market place this is a high percentage and most satisfactory from the point of view of maintaining workflow in the unit. As with any other contractor the size of margin that Works Operations would build into a particular tender figure would reflect the amount of business in hand at that point in time.

Introduction of competitive processes into the area of maintenance has been markedly slower. Typically maintenance contracts will run for several years and can require extremely detailed specifications running to scores of pages. Whereas a construction tender will normally be based on a set of drawings, a maintenance contract requires specification of service levels across a wide range of different and interlocking activities that provide for a variety of

situations. As a result of both Transit New Zealand requirements and also Council policy (for instance in the parks area) tenders for maintenance work have become increasingly common over the last couple of years.

Given the size and duration of these contracts loss of a maintenance tender will normally involve reduction in staff numbers. Historically, Works Operations undertook all maintenance activity in the areas that increasingly are being tendered. Significant maintenance tenders lost in recent years have included road carriageway maintenance (two thirds of the city), road marking (one third), refuse collection, roadside weed spraying, road median maintenance, regular CCTV inspection of sewers, EPH grounds mowing, installation of water supply submains. The Bromley/Brighton parks maintenance contract was lost in 1995 and then regained recently. There is no option with Transit NZ subsidised maintenance work other than to use the tender procedure prescribed in regulation. Failure to do so leads to forfeit of transit subsidy on the work in question. The extent and manner of tendering other forms of work (outside of City Streets) is in large part a matter of Council policy although there are some legal constraints concerning the interpretation of which there is some debate.

Although the volume of business has generally been maintained the number of field staff employed in Works Operations has fallen from 660 in April 1990 to around 380 at the current time. This reflects both loss of some work through competitive processes but also significantly the efficiency gains made by the unit which have led to the same work being done by fewer numbers.

FINANCIAL PERFORMANCE AND FINANCIAL IMPACT

The accounting framework requires Works Operations to make the required return on capital. This includes a return to the Council as property owner through the payment of market rentals on depot buildings and land. Setting these returns aside there are two areas in which Works Operations makes a clear return to the Council and one the impact of which is the subject of debate.

Over the last six years Works Operations has bettered its required financial targets by between \$500,000 and \$750,000 per annum. This is the “profit” over and above return on capital.

When the Council's audited accounts are prepared this "profit" is returned to the Policy Units and so reduces the actual costs for each of the activities below the figure of the budgeted costs. At the global level it contributes towards a reduction of the Council's operating deficit or an increase in its operating surplus.

Whenever Works Operations wins a competitive tender the job is undertaken for the Council at a price below that which it would otherwise have paid. An analysis of tenders won by Works Operations over the last five years shows that each year the Council would have paid approximately \$500,000-\$1,000,000 more to have its programme undertaken if the "second best price" is taken in those instances where Works Operations has won a tender.

These two contributions are, in my view, of an unambiguous benefit to ratepayers and have been worth \$1 million and \$1.75 million per annum on an ongoing basis.

The third area of financial impact is more debatable. It relates to the proposition that the existence of the Works Operations Unit in the Christchurch market has an impact on other contractors in keeping down prices for Council work. This argument suggests that if Works Operations were not in existence then for a variety of reasons prices would have gradually trended upwards over time with all businesses enjoying slightly improved margins and the Council having to pay more for its contracts. This argument is sometimes referred to as the impact of Works Operations in attenuating the market.

During 1995 the Council put in place an Establishment Unit to look at the possible corporatisation of Works Operations. The report from this unit led the Council to establish Canroad Construction Ltd in early 1996. On the basis of analysis undertaken on its behalf the Establishment Unit reported, *"in getting out of the business (Works Operations) the Council would be turning its back on what is seen to be significant advantages that accrue from maintaining a physical presence in the market...it is considered that the presence of the Council's own work force has a significant moderating influence on the overall Christchurch City Council roading construction market. This market is about \$18 million per year. If the general moderating effect is 1% then the value of the same is \$180,000 per year; if 10% then \$1.8 million per year. Members of the Establishment Unit felt that the moderating influence maybe closer to 10% than 1%. For the benefit of the ratepayer therefore it becomes important to find a way of maintaining a physical works presence in the market."* (Note: Members of the Establishment Unit were: Councillor Newton Dodge, Councillor Gordon Freeman, Councillor Denis O'Rourke, Martin Hadlee, John Ince, Bernie O'Brien, Jim Williamson and myself).

The evidence on which the Establishment Unit reached this conclusion essentially related to an analysis of the unit costs for certain types of roading work in Christchurch as against other main centres and other parts of the South Island. This analysis showing figures in Christchurch to be consistently and significantly lower than elsewhere. This kind of analysis effectively uses a methodology of benchmarking costs and is far from easy to undertake on a fair basis. Part of the work being undertaken over the next few months will be to see whether such favourable differential costs still exist in the roading function and to extend analysis of this sort to other activities of Works Operations.

THE PERSPECTIVE FROM THE POLICY UNITS

There is no doubt that the costs of undertaking activities have reduced significantly since 1990. One of the main consequences of this has been that the City Council has been able to very significantly increase the amount of work carried out and the standards of some work while generally maintaining rates at around the rate of inflation. For example the number of parks and reserves to be maintained has increased from 428 in 1990/91 to 652 in 1998/99. The hectares of open space have increased from 3,000 ha to 5,300 ha in the same period.

Jim Williamson (the former Director of Operations) monitored this trend from 1989 through to his departure earlier this year. His strongly held professional opinion is that the significant gains in efficiency resulted largely from the process of scheduling work and specifying standards and thereby operating on an output as distinct to an input (cost plus) basis. Competitive procedures must also have led to gains in efficiency but his consistently held view was that scheduling and specification had led to the most significant gains.

Policy Unit Managers generally share this view. This is not to deny that the tendering of all work would lead to the lowest cost outcome for the Council on specific jobs in the short term.

SUMMARY OF SITUATION 1990-98

The Works Operations Unit has been progressively exposed to competitive processes and while reducing its number of depots very significantly and its number of staff significantly has run as a successful business. It has consistently proven its competitiveness (which is not the same as saying that it has won every tender).

The approach to requiring Works Operations to compete has been steady and progressive but not rapid or aggressive. In addition to its return on capital Works Operations has consistently made a financial contribution of between \$1.5-\$1.75 million per annum. The market attenuation effect of Works Operations maybe worth significantly more than this although at the current time this is not proven.

It has always been considered that there is merit in having an in-house workforce to provide a direct capability for responding to severe weather events, rural fire or natural hazards. Although unfashionable in recent years it can also be strongly argued that construction and maintenance of infrastructure services is part of a city council's core business in which it has long standing core capabilities. Generally, when businesses have a history of doing something well they keep doing it.

On the other hand it is unquestionably the case that the specification and scheduling of work has led to substantial efficiency gains and the additional step of competitive testing has led to further significant efficiencies. If the Council were to move to a regime where significant parts of the Works Operations business was not exposed to competition there would need to be good safeguards to prevent the efficiency of the business slipping backwards. It is not clear what these would be.

THE SITUATION IN 1998

The above summary indicates that Works Operations has to date provided the Council with the "best of both worlds" by succeeding in winning a sufficient portion of work through competitive processes. Trends in recent months, however, suggest that Works Operations is under greater pressure than at any time during its previous eight year history. As outlined above the increasing tendering of maintenance activities almost inevitably means that as Works Operations "wins some, loses some" it will down-size its staff and begin to lose economies of scale in traditional maintenance areas. Secondly, the downturn in civil engineering work available in the Christchurch area over recent months has led to extremely sharp prices in some construction work (particularly roading) and severe pressure on Works Operations to maintain its market share. An accounting environment whereby it cannot use a previous year's surplus to maintain its operation during a period of intense competition accentuates this.

Meanwhile, although required by Transit regulations and Council policy to compete with private businesses for Council projects, Works Operations is generally unable to compete with those businesses for work in the commercial sector because in legal terms it is part of a local body, unable to operate outside the scope of the Local Government Act.

These three factors taken together suggest that Works Operations in its current form and with current Council policy directions is likely to become increasingly less viable. Any business needs a plan for growth for it to be healthy and maintain its morale and profitability. With this in mind a significant strand of work has been put in place over recent weeks to take the widest possible look at the future of the Works Operations. There is a window during the next 6/9 months during which Works Operations is unlikely to be significantly threatened by loss of major maintenance contracts and the intention is to use this period to thoroughly review the unit's future and its future relationship with the City Council. A working party bringing together senior Council staff Works Operations and Plant and Building Service Units and experienced business people will undertake work that is scheduled to be brought to elected members in February.

- Recommendation:**
1. That the Council acknowledge the excellent contribution made by Works Operations and Plant and Building Services Units to the efficiency of the Council's overall service provision during the last nine years and acknowledge the importance of putting in place the most appropriate framework to enable staff in the units to continue to make a strong contribution in the future.
 2. That the Council note that it may be advisable to transfer all or part of the Works Operations Unit to a corporatised structure.