Learning from experience: Purchasing legal services

A Lateral Economics study commissioned by the Attorney-General's Department

February 2011

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Elizabeth Kelly
Deputy Secretary
Attorney-General's Department
3-5 National Circuit
Barton ACT 2600

Dear Ms Kelly,

We have pleasure in presenting our response to your invitation late last year to deliberate on the matters you have been considering within the Department concerning the extent to which it is advisable to coordinate arrangements for the purchasing of legal services by Commonwealth agencies.

Our brief but intense period wrestling with the issues you face has yielded two things of substantial worth.

Firstly having reviewed reform ideas which have been produced predominantly by lawyers and managers, we are pleased to say that our own economic focus is broadly consistent with the thrust of the recent reviews of legal services purchasing, both by the Australian National Audit Office (2005, 2006) and the Blunn-Krieger Review (2009). It is also consistent with developments elsewhere, for instance in Victoria (Beaton Consulting 2006).

In making the difficult judgements necessary to proceed, it is reassuring that there is a broad disciplinary and managerial consensus on the general direction reform should take. At the heart of that consensus is the need for the Commonwealth to improve its performance as an *informed purchaser* of legal services.

This suggests greater attention be given from the centre to ensuring informed purchasing by agencies. As you know, some agencies are already performing well; others less so. We stress however, that the more centralised purchasing arrangements we have recommended make only marginal sense on their own as an alternative *form* of managing external contracting. They could ultimately make a much more substantial contribution as part of a sustained and thoughtfully governed push towards making Commonwealth agencies more informed purchasers.

Secondly, we have been able to propose some new mechanisms by which the Commonwealth can make itself a more informed purchaser. Further we think that casting legal services as an 'experience good' helps illuminate the nature of the issues in purchasing in a way that leads directly to ways of intensifying the incentives firms face to perform well.

These potential additions to the repertoire of Commonwealth agencies as purchasers of legal services offer the prospect of taking the Commonwealth to the forefront of good practice amongst government or major private sector purchasers of legal services anywhere in the world.

I would also like to thank all those in government and in private legal firms who gave their time to help us with our project and particularly Carmen Miragaya and Tracey Smith from your Department both of whom went out of their way to help us get up to speed in any way they could.

Please accept my thanks for your faith in us.

Nicholas Gruen
Chief Executive Officer
Lateral Economics

9th February 2011

Executive Summary and recommendations

> There is only one thing more painful than learning from experience and that is not learning from experience.
>
> Archibald McLeish

Introduction

The Commonwealth spends upwards of $600 million on purchasing legal services each year, with most of that spending on legal services from the private market – though the Commonwealth owns the dominant player in that private market – the Australian Government Solicitor (AGS). Managerial hygiene dictates that the Commonwealth should be vigilant in its search to optimise the value for money it receives for this expenditure and in pursuit of this goal there have been a number of inquiries, since the last major shake up in the late 1990s. Lateral Economics has been asked to explore the relative merits of a range of proposals which have been developed in consideration of the Blunn-Krieger Review conducted in 2009.

At the heart of the issues is the tension between centralisation and devolvement. In the wake of the Logan Report in 1997 authority for obtaining legal services was fully devolved to agencies. Yet there are some ways in which the Commonwealth can advantage itself by having some co-ordination between the agencies. Most obviously agencies have a collective interest, which is to say the Commonwealth has an interest in agencies sharing their knowledge about where and how to get the best value for money. They may also have an interest in pooling their buying power.

Yet the means by which it has been hoped to finesse these issues – the Office of Legal Services Coordination (OLSC) – has neither the resources nor the authority to perform its role. This is not an uncommon situation in the Commonwealth where agencies are accountable both for achieving ministerial and agency specific objectives whilst doing so consistently with some agency or government wide policy. There are parallels between this area and the Commonwealth's purchasing of information and communication technology (ICT).[1] In his Review of the Government's ICT use in 2008 Sir Peter Gershon concluded that previous emphasis on the autonomy of individual agencies had left

[1] Note for instance Ian Reinecke quoting a Departmental CIO commenting "AGIMO acts with one hand tied behind its back - it is too dependent on agency goodwill". Similar views have been expressed to us regarding OLSC.

important deficits in the whole-of-government coherence of ICT management and agency purchasing capability. Similar findings were made by Blunn-Krieger and our own study.

The current market

A central message of our study is that legal services are pre-eminently 'experience goods'. It will often be difficult to ascertain the quality of legal services until one has purchased and experienced them. Yet they are purchased as if they were simple 'search goods', as if with sufficient due diligence one could ascertain the quality of legal services before purchase. And little effort has been expended in ensuring that agencies learn from their own and other agencies' legal purchasing experience.

Because of the complexity of legal services and their uniqueness to context, the pre-eminent qualification for obtaining value for money is to be an *informed purchaser*. Good purchasing also requires active collaboration and trust between purchaser and provider. Yet the Commonwealth Purchasing Guidelines (CGPs), or agencies' interpretation of them, has created a default procedure which fails to emphasise what is most important about optimising value for money.

Agencies require legal services, often urgently, but to purchase them creates a 'purchasing event' compliant with the CPGs. For purchases below $80,000 agencies feel the need to already have arrangements in place which ensure that an urgent purchase is compliant. Overwhelmingly the have adopted the following procedure:

- Each agency with any volume of legal services purchasing establishes a panel of service providers through an extensive pre-qualification process. This involves an open, competitive tender, the passage of many months and the expenditure of tens if not hundreds of thousands of dollars by both the agency and firms seeking selection to the panel.
- Selected firms then provide the bulk of legal services. There may be 'sub-panels' for specialist work and 'mini-tenders' or competitive quotations for particular pieces of work to promote in-panel competition.
- The panel runs for a period of time – typically three years – with provision for extensions at agencies' option.

Problems with the current market

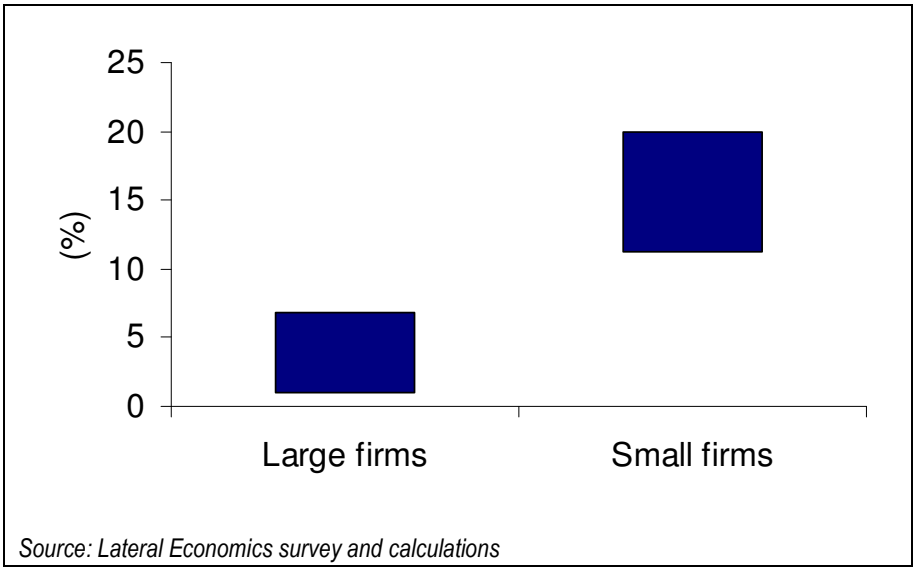
Agencies' gravitation towards this model is not primarily motivated by optimising value for money, though it is hoped that the prize of access to panels will intensify competition on price between firms (mostly in the form of lower hourly rates). Rather the *establishment* of the panel is

deemed the relevant 'purchasing event' under the CPGs and so, providing this process is meticulously documented and run, agencies are then free to contract with panel firms without further formalities.

The central problems to which this architecture gives rise are as follows:

- Panels act as a strong barrier to entry to smaller firms. Agencies have a preference for dealing with larger, full-service firms with their spread of expertise. But the panel system exacerbates this. It is regarded as best practice not to have too many firms on panels, but this means that smaller, more specialised firms pose more of a risk to agencies. In addition – and partly as a result of this – small firms appear to be less successful in qualifying for panels and as a proportion of the value won, they are much costlier for small firms to qualify for (see typical ranges for small versus large firms in the following graphic).

Chart A: The range of tendering costs as a proportion of panel work won: large versus small firms



Source: Lateral Economics survey and calculations

- Panels are also a barrier to normal market development. Unless exceptional circumstances intervene, firms cannot be brought onto a panel, or taken off tor the duration of that panel's existence (however, the amount of work they are asked to do can be varied). Panels normally last at least two years and options for two one year extensions are common. We are aware of one arrangement in which, in addition to a normal three year term for a panel, contemplates the possibility of three two year extensions which if exercised could mean a nine year period without any opportunities for new service providers to participate.

- There is a great deal of duplication. OLSC is aware of 72 panels, each maintained by a particular agency. For each of them many firms will have responded to lengthy tender documents often taking many months to prepare,[2] many months for firms to respond to and many months to assess. Compared with the costs of running the reformed system we propose this duplication costs of the order of 2 to 2¾ per cent of the total costs of purchases in tendering alone.

- Yet the greater cost of this fragmentation is likely to be not in duplicated tendering costs, but in the fragmentation of buying skill. Informed purchasing in this difficult market requires a great deal of skill and systems which effectively capture, share and learn from information about ongoing experience. We need far fewer than 72 nodes of informed purchasing to efficiently make use of what are relatively scarce purchasing skills available to the Commonwealth.

- Panels obstruct external talent management by the Commonwealth. Agencies inevitably contract with firms, but often value specific personnel within them. The more formality around the relations with the firm, the less flexibility the agency has to manage the external talent to which it seeks access. If specific partner(s) or legal teams left a particular panel firm to join a firm that was not on an agency's panel, the agency could be prevented from obtaining continuity of service from the personnel to whom it had sought access in selecting a particular firm for a panel in the first place.

- This approach to compliance with the CPGs does not focus on, can obstruct and sometimes serves to displace the single most important thing that agencies can do to optimise value for money – which is to become skilled and knowledgeable as purchasers of complex experience goods and to keep those skills and knowledge honed and used continually in managing external service providers.

Panels or multi-use lists: The centre or the periphery?

Our survey data suggested that the costs of establishing panels accounts for nearly 4 per cent of the cost of expenditure though them.

[2] The *Legal Services Directions 2005* mandate the use of a standard request for tender containing tender terms and some guidance for agencies. It is over forty pages long.

Orienting panels around broad subject areas of commonly required legal expertise, such as employment, administrative, property and commercial law would

- Reduce tendering costs by around one half to three quarters.
- Better project the Commonwealth's buying power.
- Provide the opportunity for more *informed purchasing* both by focusing skilled resources around a much smaller number of panels and also by ensuring that skilled panel managers assist those agencies using their panels that are not informed purchasers.

Recommendation 1: Panels should be established in specific areas of law with substantial Commonwealth demand rather than agency-by-agency.[3]

Each panel should be established and managed by the legal practice of an agency judged by OLSC to the most informed purchaser with an interest in the area. The panel manager would be custodian of performance information guiding purchasers in their search for best value for money in the relevant legal area.

Subject to other recommendations, where agencies are not judged by OLSC to be informed purchasers, they would be obliged to purchase from these panels for appropriate legal matters. For a fee (to be set in consultation with OLSC to cover relevant costs) the panel manager would advise and mentor buyers of legal services from such agencies seeking to purchase from the panel.

Agencies judged by OLSC to be informed purchasers would be obliged to attempt to maximise their purchases of services within specific fields from the relevant panel in consultation with the panel manager. They could also seek to negotiate better rates than the general panel rate with panel firms.[4] However should informed purchasers wish to negotiate their own arrangements outside the panel, on presentation of their reasons to OLSC they should be free to do so.

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[3] One such area would be general legal services as required by most agencies. It would also make sense to start with discrete areas of law that apply in relatively uniform contexts across Commonwealth agencies as other initial candidates for subject-oriented panels. Agency requirements in terms of more complex, or highly specific areas of the law could be satisfied via the proposed multi-use list.

[4] It may also be appropriate to charge such informed users of the panel some low fee which represents the cost of establishing the panel. On the analysis in this report this figure should be below 1% per cent of the value transacted.

Those wishing to purchase legal services on matters outside the areas provided for in the panels could choose from pre-qualified providers on a multi-use list maintained by OLSC.

Specific agency needs

Even with their needs met with panels in general subject areas, agencies will continue to have specialist needs around portfolio-specific legislation and issues. Where subject area panels do not provide satisfactory options, agencies could resort to firms on the multi-use list. The multi-use list would centralise basic administrative tasks required to qualify firms. A multi-use list could also pre-qualify the capabilities of firms. Doing this centrally would reduce a great deal of duplication that occurs in panel tendering.

Once providers' capabilities are itemised on the list, agencies could easily identify which firms were qualified to assist with agency-specific work. In appropriate circumstances – typically with larger matters – agencies could ensure they received value for money by obtaining competitive quotes from selected qualified providers on the multi-use list (as they would often do within a panel). But providing a purchase was not over $80,000, they could also purchase services by approaching single firms qualified to do the relevant work from the list whilst subjecting all such work to ongoing scrutiny of their general matter-management system to determine value for money both directly by being an informed purchaser, and indirectly because firms would understand that better value for money work would likely be rewarded with further business.

The agency could also project its buying power in the context of a multi-use list. It could hold a simple 'price tender' between firms already identified as qualified. Here providers would identify the price they would be prepared to pay to receive some specified amount of work or to be on an informal group of preferred suppliers within the multi-use list. To the extent that a tender for a panel is a 'purchasing event' under the CPGs which discharges the CPGs requirement for agencies to obtain value for money, this procedure would perform the same substantive function as the establishment of a panel. It would demonstrate value for money (capability plus a competitive price) and, particularly if the agency was an informed buyer, the price tender should also satisfy as a purchasing event, enabling the same kind of informal and immediate access to service providers as is provided by a panel.

Ongoing promotion and relegation to a group of pre-qualified providers

As information systems improve it should be possible to adopt more streamlined and flexible approaches. Where a panel provides a formal

structure within which it is hoped that close relationships can develop, some firms, such as BHP Billiton simply establish close relationships with firms without the formality of a panel. Where discounts can be obtained from service providers within a panel, it should be possible to negotiate them outside the panel, by holding out rewards in the form of greater volume or more stable demand in return for lower prices. And at the same time, the group of firms which are known to represent good value for money suppliers can be kept open for newcomers who can prove themselves and challenge incumbents.

Where information systems have been developed which can document this process of ongoing assessment of value for money and the manager of the relationship with firms can demonstrate the openness of the process to competitors from outside, it should be possible for such arrangements to comply with the CPGs. For the CPGs require the purchasers to demonstrate that they are achieving value for money through open competition, something which could be demonstrated by detailed performance information, ongoing market development arrangements such as those discussed above and the variation of levels of work and promotion and relegation of providers into the preferred group depending on performance.

Ameliorate the way panels discriminate against smaller firms and impede market entry and development

> The internal cost of tendering for the panel significantly outweighed the revenue received for the first two years.
>
> Small firm response to our survey on panel tendering costs

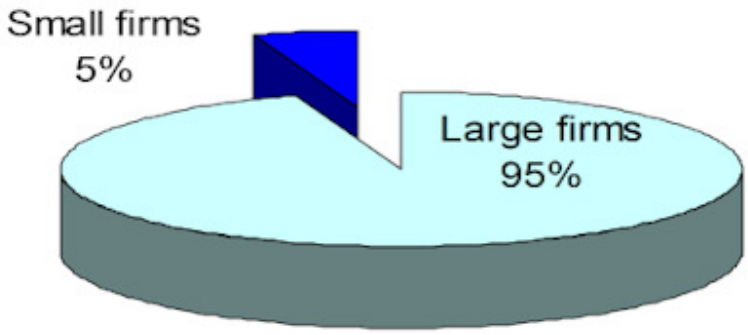
There is a clear tension between the extent to which legal services are *experience* goods and the extent to which tenders seek to lock purchasers into assessments of firms' suitability *in advance*. In a market for experience goods, buyers will want to limit their risk with new suppliers until they gain sufficient experience with small, low risk purchases. The current system erects a Catch 22 in the pathway of such possibilities: Agencies are loath to empanel new providers until they have experience with them, but new providers cannot get experience until they qualify for a panel.

Similar considerations militate against agencies accessing smaller, more specialised firms. Large firms' spread of skills is desirable and many agencies will always direct a sizeable proportion of their purchases to full-service firms. However, when an agency commits to a limited number of suppliers on a panel to pursue close collaboration with each, it is riskier for it to do this with more specialised suppliers – as this

provides it with less flexibility and competitive alternatives if a supplier performs poorly or is conflicted in a matter.

More generally in the area of government purchasing, governments have been at pains to ensure that agencies procedures do not discriminate against small and medium and emerging firms. This is done to foster the innovation and market development that smaller firms can bring. The CPGs commit the Government to sourcing 10 per cent of its purchases from small to medium sized firms.[5] In this market however, our analysis of data held by OLSC indicates that legal services provision falls well short of this benchmark. It is also well below the result obtained across the Commonwealth where about 32 per cent by value and 56 per cent by volume of contracts go to smaller enterprises.[6] In many respects this is surprising given the lack of obvious scale economies in legal services.

Chart B: Proportion of small and large firms supplying legal services



Source: Lateral Economics classification using OLSC data

Agencies seek external provision with many different requirements. They may only need serviceable work, or they may need reassurance that they have accessed the best expertise there is. They may wish to access a firm with a broad spread of skills for a complex or geographically widespread matter, and/or they may wish to purchase advice that comes from, and can be demonstrated to others as coming from a very highly reputed 'brand'. Given the attractions of all these

[5] CPGs § 5.6 reads as follows: "The Government is committed to FMA agencies sourcing at least 10 per cent of their purchases by value from SMEs."

[6] Correspondence from the Department of Finance and Deregulation.

characteristics, firms price for them. Each accretion of value comes at a cost. Thus optimising value for money means that the Commonwealth should as far as practicable purchase only those services that it needs. Often, for instance, an agency will want a high level of expertise, but particularly if the work is for its own benefit, and not for publication, they may be indifferent to whether or not the work comes with the 'brand' of a top-tier firm.

Further, although agencies necessarily contract with *firms*, to a substantial extent their reason for doing so is to work with *individual* lawyers and teams that they regard highly. Given that professional services firms charge premiums for the spread of skills that they offer, if an agency has the skills to assemble and effectively use smaller providers, they may in some cases be able to save themselves the margin of dealing with a large firm by performing some of the skill aggregation themselves rather than pay for this service from firms.

Recommendation 2: Where panels are established, some small portion of the expenditure on panel firms, say 5 per cent (growing to 15 per cent over the course of the panel's existence), should be available to be spent outside the panel, particularly on smaller service providers offering better value for money.

Out-of-panel purchasing should not be mandated, but would be encouraged up to the specified percentage level. The panel manager should provide some means for assisting agencies to chose out of panel providers cost effectively.

Implementing this recommendation would also make it easier for agencies to engage those regional and smaller firms that had not qualified for panels on an *ad hoc* basis where it made sense without undermining the integrity or the advantages of panel arrangements.

Enhance the future value of good reputation and simplify tendering where possible

Reputation (often captured in a recognised brand) is the central means by which consumers protect themselves in circumstances where they have imperfect information about the goods they are buying. A system which measures the quality of service providers' performance and which circulates that information would enable purchasers to piggy back off each others' experience and evolving knowledge. This not only ensures the 'static' benefit that agencies are better placed to make the right choices in service providers, it incorporates dynamics that are extremely desirable in an otherwise difficult market. The more service providers are focused on impressing their existing clients to win future work from them, the more this enhances their tendency to virtuous behaviour. Reputation leverages this effect because it extends the future rewards (or penalties)

arising from impressing (or disappointing) one client to the prospects of working for other clients.

Agencies can further intensify those incentives by rewarding the best performers not just with more work, but with less onerous requirements for obtaining further business. Reputational information would be generated by ongoing appraisal of service according to definitions which were consistent across Commonwealth agencies (see Recommendation 4)

Recommendation 3: Where agencies are judged by the Attorney General's Department (advised by OLSC in its role as secretariat to the GCCG – see below) to be informed purchasers, those agencies should be permitted to offer their best service providers streamlined means for qualifying for further work, including future panel membership.

To achieve better value for money purchasing of legal services, we must candidly acknowledge their status as experience goods and dispose of the fiction that *ex ante* assessments of future performance are more reliable than actual performance as experienced by informed Commonwealth purchasers.

Ensuring agencies are informed purchasers

> The issue of agency capability is critical to the reform program for Government ICT. Unless agencies had the internal capability to implement whole-of-Government policies there could be no discernible benefit from having developed those policies.
>
> Dr Ian Reinecke's review of the Gershon Report Implementation, 2010, p. 10

On the limited data we have been able to obtain in the time available for this study, on their own, our proposed changes to the complex architecture of agency panels could be expected to produce ongoing annual cost savings of the order of 2 to 2¾ per cent of total costs or $5 to $7.5 million per annum. These gains would be worth having on their own but are not large as a share of total external legal services spending. However as we have proposed them, they are part of the larger plan to get Commonwealth agencies to become more informed purchasers. Many need to become more informed about their own purchasing. And all agencies need to become more informed about *each others'* purchasing, for this has implications for their own activities, not just in terms of skills and lessons that might be shared, but can also enable them to know and select their suppliers better. And the evidence

suggests that informed purchasers of legal services place themselves in a position to obtain much better value for money.

Virtually all agencies agreed that sharing information was critical to better performance. Yet they are not good at sharing what they know – with each other or with the OLSC - which has the role of reporting on aspects of the system and assisting agencies with their legal services arrangements. Though it has this role, it has not been given the necessary authority or resources to effectively carry it out. Yet this is not very surprising. For the in-house legal practices from which it must obtain the information are not principally accountable to OLSC, but rather to their own secretaries.

Given the potential for information to be used and reused without limit, not to enable agencies to learn from each other's experience might be regarded as a misfortune. But given that legal services are 'experience good', and the strong resulting consensus that to buy well agencies must be *informed purchasers,* not helping them learn from each others' experience looks like carelessness.

Even here, however there are dilemmas. For their own good reasons, agencies collect information in different ways, using different systems which use different standards. At least here, there is something sensible that can be said about the dilemma from first principles. While these agencies were designing these systems, their collective interest – the Commonwealth's interest and the public interest – in their sharing that information should have been more explicitly brought to account in their decisions.

That this should be put right is, fortunately, both the least contentious and most important suggestion of this report. It is also possible to state with great confidence *how* it should be put right, though, because it requires a group of people and agencies to co-operate productively, it must rely on their good will. It would be possible to conclude from what has been said that some common system for capturing information from agencies as they manage their purchasing of legal services should be imposed on agencies. Yet if this were done, not only would it meet stiff resistance, but it would quite likely be the wrong answer. In other areas (e.g. statistical collections), for example, rather than completely re-engineering their systems, agencies agree to produce so called 'minimum datasets' compiled from existing systems according to agreed definitions and common standards which can then be shared among interested parties. This can then serve as a platform for growing co-operation over time.

Recommendation 4: A General Counsels' Coordination Group (GCCG) should be convened comprising 6 to 8 highly regarded General Counsels from agencies with a representative mix of legal practices.[7] With the OLSC resourced to act as its secretariat, the GCCG should:

A. **Agree a plan to harmonise the information standards by which all agencies manage their legal purchasing and assess the value for money they are achieving to enable data to be comparable so that it can be shared.[8]**

   The aim should be to introduce a Commonwealth-wide means of electronically recording performance appraisals of and interacting with service providers with common definitions and standards to ensure that relevant agency information is captured and easily shared across agencies.

B. **Assess the capability of all Commonwealth agencies making substantial legal purchases to be informed purchasers.[9]**

C. **Produce and implement a plan to raise those capabilities to an acceptable standard.**

D. **Produce a plan to build collegiality and skill sharing between agency practices to lift service wide capability in an ongoing way.**

To avoid delays in progress, clear timetables and public benchmarks of success will be necessary alongside an alternative plan to impose more centralised solutions if the GCCG fails. As occurred with the Reinecke Review of the Gershon reforms, there should be a review of progress after an appropriate period.

Benefits from reform

Lateral Economics was requested to quantify the benefits of these proposals. Even though some of these gains can only be quantified in the most broad and indicative manner, keeping a 'best guess' of potential gains from different sources has been a worthwhile discipline in determining where we focused our own energies. In fact all the reforms

[7] Membership from one or two highly regarded buyers of legal services from large private corporates could also be useful.

[8] It may be appropriate to decide basic standards relatively quickly, with a second round of more thorough standards agreed after experience with the information generated initially.

[9] 'Substantial' legal services purchases should be those over some threshold decided by the GCCG.

we have proposed are interrelated. But isolating them for the purposes of itemising the relevant cost reductions to which we think our recommendations could lead, we divide them into three categories as per the following table.

Table A: The prospective gains from change

Change	*Quality gains*	*Risks*	*Potential Gain (%)*	*Potential Gain ($/pa)*
Reducing tendering costs	Possible if appropriate model	Low but non-negligible	2 – 2¾	5 to 7.5 million
Exploiting market power	Negative	Moderate	2½ - 4	6.5 - 10 million
Better informed purchasing and external talent management	Positive [10]	None	7 – 15	18 - 38 million
Total			**11½ – 21¾**	**29 – 56 million**

Establishment costs account for around 3.85 per cent of the total cost of legal services purchased through panels. Reducing the number panels from around 72 to around 10 should see establishment costs fall by 50 to 75 per cent which would amount to around $5 to $7.5 million. Likewise this rationalisation of panels should enable panel managers to secure better deals from firms seeking to qualify for panels. It was not possible to obtain data on the extent to which panel size correlated with discounts offered by firms. Our soundings in industry and reading of the literature suggest that discounts of the order of 20 per cent are available to large buyers. Assuming that most such discounts are already captured by the larger panels, we suggest gains of between 2½ and 4 per cent or around $6.5 to $10 million should be possible.

The recommendations in this report should lead to better informed purchasing which can be expected to produce gains of the following kind.

- All agencies will be better informed about *other* agencies' experiences with external providers, leading to more rapid and sure-footed responses to quality and price signals from providers.

[10] See Dore, 1983, p. 475.

- Agencies will be able to pinpoint how much work particular partners in firms and their teams are doing for them (and others), enabling better external talent cultivation and management.
- More focus on a disciplined environment for systematic prediction and ongoing measurement of the accuracy of predictions – of such things as the cost of matters and their likely outcome – should lead to improvements in the efficiency of work allocation and the more rapid identification of and learning from emerging best practices.
- Better market development, including purchasing from smaller firms with knock-on benefits in terms of price discipline in the case of larger firms.
- Reduced duplication where multiple agencies seek advice on the same matter of law either without realising the duplication or realising it, being unable or unprepared to share other agencies' work.
- Better management of routine legal matters by agencies that are not currently informed purchasers.[11]

Given all these potential benefits we believe the cumulative benefits available from the advantages of informed purchasing could be conservatively estimated at between 7 to 15 per cent.

[11] The ANAO reported in 2005 that "a large percentage of agencies were not satisfactorily monitoring performance of providers and dealing with deficiencies as those arose suggesting a large majority are not informed purchasers. We conducted a very informal 'straw poll' of agencies and firms asking what proportion of commonwealth spending on external legal services was by informed purchasers. The responses ranged from 25 to 80 per cent. If becoming an informed purchaser could reduce costs by 15% the range of benefits implied by these responses is between 3 and 11.25%.

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I. Introduction and background

Currently running at around $640 million annually, the Commonwealth market for legal services is significant enough to attract supplier firms running into the hundreds (e.g. some 291 legal service organisations were identified as suppliers to the Commonwealth in 2009-10). There is a ready external market to satisfy Commonwealth demand for legal services, notwithstanding that such work would nevertheless represent a modest proportion of most large law firms' overall revenues (particularly larger, full-service practices), though a dominant share of the work conducted by their Canberra offices.

Apart from external firms, the other important source of supply of legal services to the Commonwealth is internal, in the form of in-house legal teams located in government agencies. As a source of supply external providers are only somewhat more important than internal ones. 55 per cent of these costs are accounted for by external legal firms, although one of them, the Australian Government Solicitor (AGS) is a government owned enterprise which was separated from the Commonwealth Attorney-General's Department in a series of deregulatory reforms in 1999 following the Logan Report in 1997. AGS has a dominant presence with a 43 per cent share of this external market for legal services.

Legal services are not like many other goods and services bought and sold in the marketplace mainly on the basis of price. Like other professional services, legal services embody various characteristics — apart from their price — which consumers take into account when they procure such services. Thus in judging whether to engage a particular law firm on a matter, the prospective purchaser will likely take into account the firm's track record in handling similar matters, the particular individual (or individuals) within the firm who will work on the matter, the reputation of the firm for timeliness, responsiveness, the business relevance of their services as well as the likely cost.

It is a commonplace of analysis of this market that buyers must be well informed about what they are buying if they are to achieve true value for money. In their recent report reviewing Commonwealth legal services procurement, Blunn and Krieger (2009) describe them as:

> those professional services used by agencies to determine their legal position on issues, to manage legal processes, to advise on managing legal risk or achieving results lawfully, or to document contractual or other legal obligations.

This is a much narrower definition, for example, than that used by the Australian Bureau of Statistics (ABS) in compiling statistics on legal

services (e.g. in its *Legal Services, Australia* series of publications), — which defines legal services as comprising:[12]

> legal representation and advice, the preparation of legal documents and title-searching services (i.e. establishing the legal ownership of a property).

The Commonwealth's legal spend has been growing over time, although that growth appears to have slowed in the last few years. Thus based on estimates drawn from various sources over a decade and a half, it would appear that the Commonwealth's internal legal spend has been growing in real (inflation adjusted) terms at a much greater rate than its external spend (23.3 per cent per year, on average, versus 7.9 per cent) — although the former could have been significantly affected by under-reporting problems in the early part of the 15-year period (see Appendix A).

According to the latest legal services expenditure report compiled by the Office of Legal Services Coordination (OLSC), the total legal spend for Commonwealth agencies for 2009-10 was up 3.3 per cent on the corresponding figure for 2008-09. Since prices for these kinds of services, as measured by movements in ordinary time hourly rates of pay (excluding bonuses) for *Private, professional, scientific and technical services* compiled by the ABS rose by 3 per cent between the 2008-09 and 2009-10 financial years, the Commonwealth's legal spend in real (i.e. inflation-adjusted) terms rose only modestly (up by only an estimated 0.3 per cent over the twelve-month period). However given the growth of the economy and the population over the period, a real rise of 0.3 per cent represents a small *decline* in real per capita spending on legal services.

The longer run history is provided in the following graph, which depicts estimated real Commonwealth legal spending over the last 15 years —

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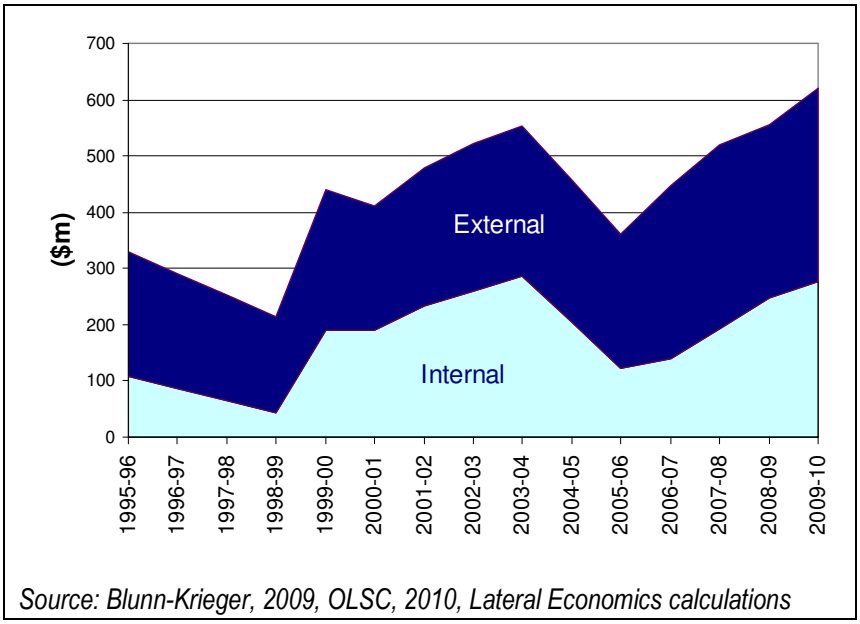
12 ABS (2009), *Legal Services, Australia, 2007-08* (Cat. no. 8667.0), explanatory notes.

There is also the widely held view that legal services are of a qualitatively different kind than other professional services, with Blunn and Krieger (2009:16) describing the difference in the following terms:

> Providers of legal services have obligations beyond those owed to their clients — for example, obligations to the courts in litigation matters and professional, ethical and fiduciary obligations in all matters. This is so even if the 'client' is also the employer of the legal service provider in question. At its core, the relationship between client and legal service provider is one of trust and confidence, as is recognised by the special position given to it by law. That confidence depends largely on the knowledge, understanding and judgement of the service provider, often an individual.

although as Blunn and Krieger (2009:21) notes, the data suffer from inconsistent definitions and questionable coverage over time. In particular it is unclear the extent to which recent recorded growth in internal spending reflects greater internal spending as oppose to increased vigilance in tracking that expenditure.

Chart 1: Real Commonwealth spending on legal services: internal versus external



Source: Blunn-Krieger, 2009, OLSC, 2010, Lateral Economics calculations

Cognisant of the large financial commitment the Commonwealth makes to the purchasing of legal services, the Attorney-General's Department is considering options for improving the Commonwealth's arrangements for such purchases. The last major government-wide restructuring of arrangements for purchasing of legal services occurred in the wake of the Logan Report in 1997.

Reflecting the deregulatory zeitgeist of the late 1990s, individual agencies were given (and retain) substantial autonomy to make their own arrangements. That autonomy is nevertheless constrained, as one might expect by the Commonwealth Purchasing Guidelines (CPGs). Further, it must be consistent with the Attorney-General's Legal Services Directions (LSDs). In addition, as its name suggests, the Office of Legal Services Coordination (OLSC) within the Attorney-General's Department attempts to play a coordinating role in legal services purchasing across the Commonwealth, though its focus is largely on securing agencies' compliance with the LSDs. In the upshot, Commonwealth agencies with substantial legal services budgets (and others with much smaller legal spends) maintain panels of firms which have typically been prequalified by open tender to perform services for them on an ongoing basis.

While there are no alarming signs of mismanagement or of recent rising costs,[13] with the Commonwealth spending well over half a billion dollars on purchasing legal services both within its own agencies and from external commercial legal service providers, periodic review is warranted as a matter of managerial hygiene. There have been significant reviews recently from an Australian National Audit Office (ANAO) performance audit (2005) followed by an ANAO Better Practice Guide (2006) to the completion of a review by Anthony Blunn and Sibylle Krieger (2009).

The Department seeks Lateral Economics' views on major aspects of the Blunn-Krieger Report. Most particularly it seeks an understanding of the likely market impact of alternative procurement models proposed by Blunn-Krieger.

The Department is considering four possible arrangements by which the Commonwealth would pursue its purchasing of legal services or a combination of these approaches:

- The current arrangement where agencies purchase services themselves;
- A more centralised arrangement where agencies purchase predominantly from a central panel. Here the due diligence that is now done by agencies in establishing their own panel would be done centrally. Rationales for such a move include that:
    - it would lower costs for both firms and agencies in tendering for panels and assessing those tenders; and
    - central arrangements might better exploit any market power the Commonwealth has in purchasing legal services.

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[13] The Office of Legal Services Coordination within the Department of the Attorney General reports that "In 2009–10 expenditure by FMA agencies increased by 2.9%, down from an 8.3% increase in 2008–09." The latter increase was driven in part by increased efforts to identify legal services expenditure within agencies and thus to some (unclear) extent overstates the increase in actual expenditure on legal services. Given the rising cost of living the faster rise in the cost of professional remuneration and the natural growth in the economy, *prima facie* this looks like a good result. Note also that the last financial year 2009-10 was only the second year in which new reporting obligations governed the collection of data on legal services spending by agencies and so the first year to generate year on year comparisons based on consistent definitions and practices. Nevertheless even so the OLSC considers that some in-house legal costs remain under-reported. Note the total spend taking into account 6.5% growth in CAC agencies comes to 3.3% (OLSC, 2010, p. 2, 4) though CAC agencies, having substantially lower purchases of legal services may be taking longer than FMA agencies to correctly itemise all legal expenditure and if this is the case the true rate of growth of legal services spending within CAC agencies may be closer to the reported FMA rate.

- An arrangement where agencies purchase from a multi-use list which would centralise a much more summary 'due diligence' process to be augmented by agencies' own further selection processes.
- A hybrid arrangement where there is a central panel of major suppliers with a centrally run multi-use list of smaller niche providers.

The Department also sought Lateral Economics' further views on additional measures that might be taken to further optimise the value for money the Commonwealth receives from its purchases of legal services.

II. The dilemmas of the current situation

Contracting legal services presents a range of challenges which take it out of the simple textbook exercise of outsourcing where what is wanted can be clearly specified and competition between alternative providers drives prices down and quality up. For the buyers of legal services their quality and other non-price attributes are often paramount (Tunca, et al, 2010, p. 2) though of course the right price is always important.[14] The fact that competition takes place over multiple dimensions – for instance price, quality, timeliness, responsiveness, relevance – means that tendering is not a straightforward business. This would be the case even if those dimensions were easily measured. Yet we know that many are difficult enough to measure after the event, let alone able to be clearly specified beforehand.

Further, it is generally the case that contracts cannot fully anticipate all possible eventualities, and are therefore incomplete – a problem the law wrestles with in determining implied terms of contracts. This problem bedevils the provision of sophisticated legal professional expertise. Here the problem known in the economics jargon as 'incomplete contracts' looms larger than in many other areas.

In fact the contracts written between Commonwealth agencies and their service providers will almost never be enforced through litigation or even its threat. As with the contract under which this report was completed, though the contract contains provisions which would enable litigation in the event of egregious breach, it is mostly better seen as a framework governing a relationship of service, direction, feedback and mutual accommodation between the parties.

Asymmetric information: Search, experience and credence goods

For markets to function, buyers and sellers must know what the deals they strike are getting them into. Thus a central dilemma explored in the economics of information is the situation where one party to a transaction knows more than the other or, to use the jargon, where markets are characterised by 'asymmetric information'. In his landmark article "Information and Consumer Behavior", economist Philip Nelson

[14] The importance of quality is well understood when one considers that a piece of advice to or litigation for the Commonwealth could cost in the tens of thousands but may influence liabilities worth tens of millions or even billions. This is one of a wide class of situations about which Kremer's (1983), 'O-Ring theory of economic development' is relevant. Kremer's schema is well captured in its name. The O-ring was a single faulty part on the space shuttle which scuppered billions of dollars of investment.

(1970: 312) explored two such situations. Sometimes one needs to spend time and resources searching for the right goods.[15] With other goods satisfactory information only comes only with experience of the good and thus, generally, after purchase.

> The most obvious procedure available to the consumer in obtaining information about price or quality is search. . . . . A consumer trying on a dress differs from a consumer determining the price of a dress only because the time required to try on a dress is longer. But there will be goods for which this search procedure is inappropriate, goods it will pay the consumer to evaluate by purchase rather than by search. . . . To evaluate brands of canned tuna fish, for example, the consumer would almost certainly purchase brands of tuna fish for consumption. He could, then, determine from several purchases which brand he preferred.

Shortly after Nelson's article, Darby and Kami (1973, p. 67) distinguished a third important source of asymmetric information. Here the consumer of a good has difficulty determining its quality *even after* experiencing it. Such 'credence goods' are exemplified by expert practitioners who both diagnose the problem and then contract to fix it – such as car mechanics or medical practitioners.

Professional services in general, and legal services in particular, often have aspects of all three of these characteristics – they are in part search goods, experience goods and often have aspects of credence goods. The fact that legal services are a 'search good' is one, though by no means the only, explanation for the lengths to which agencies go to identify their needs in advance and to undertake elaborate processes to establish panels so that they can then search within a restricted number of potential suppliers for legal services that can meet their needs at the best price achievable.

Once panels are selected, sourcing decisions will often be influenced more by experience *ex-post* than by search. Often the agency's first opportunity to really verify the quality of a firm's work will come after it has used the firm for a period of time. While the relevant purchaser will seek to 'look forward' to choose the best alternative provider, much of their perspective will be a retrospective one – reflecting the characteristics of legal services as an experience good. Because of the size and constancy of its purchases, the Commonwealth has (or ought to have at its disposal) a great deal of experience of past purchases on

[15] In this discussion, the expression 'good' stands for goods *and services.*

which it can base its expectations of the likely quality of future purchases.

Naturally, for the Commonwealth to actually learn from past experience that experience needs to be captured. And that experience can be 'leveraged' if it is shared either informally, or – more desirably – formally. The Commonwealth Purchasing Guidelines recognise that agencies purchase experience goods in paragraph 4.4 (b) which instructs them that, in addition to cost, a range of matters should be considered including "the performance history of each prospective supplier" (2008, p. 6.).

And as Rubin (2004) argues [16] legal services also exhibit credence goods characteristics arising primarily from the complexity of the law and the potential uniqueness of each case, requiring judgment on the part of the expert – judgment that is difficult to assess without having done the work they have. This is particularly a problem for non-experts. In this regard, although the Commonwealth is far from a novice buyer, not increasing its own knowledge of a particular case in order to reduce the extent to which work is purchased on credence could prove costly. Reflecting the remaining 'credence' aspects of the relationship, where the purchaser must trust the seller, there is a premium on the purchasers' faith in the service provider's integrity. As Cowton 2008 points out, the likelihood that some part of professionals' service is bought on credence provides some insight into the practical significance of professional ethics and the value of professionals taking their professional ethical obligations seriously.

Purchasing relationships: insights from transactions cost economics

> Legal services procurement is a personal service industry where relationships are critical to obtaining value but relationships need to be carefully managed.
>
> FAHCSIA communication with Lateral Economics.

Managing the contractual relationship for the purchase of expert professional services is far from straightforward for either party. The goods purchased can be highly complex and can have aspects of uniqueness for each job. And there are information asymmetries between buyers and sellers as outlined in the previous section. As a result successful purchasing is both sophisticated and amenable to different approaches. In our consultations it was clear that a number of

[16] Cited in Causholli (2009, p. 22).

different approaches were being taken to purchasing by expert purchasers, several of which appeared to be successfully delivering value for money. All of the purchasers who impressed us as most skilful and diligent in their task, and all suppliers, agreed that the best value for money emerged from high-quality, collaborative relationships between purchaser and provider.

In this regard it is instructive to compare public sector procurement with procurement in the private sector. As Kelman observed (1990), in general private firms use open auctions much less commonly, leave higher margins to suppliers,[17] and switch suppliers less often than their public sector counterparts.[18] If this suggests that private sector purchasers are trying less hard, they remain more satisfied with their purchases (2009, p. 3). Whist one might be wary of simply presuming that the private sector is more efficient in all things than the public sector, in this case there are reasons to believe that that private sector experience and behaviour has important lessons for the public sector.

For within the private sector over the last few decades it seems fairly clear that large firms have moved more towards purchasing arrangements which rely less on purely competitive tendering at arms length and more on the development of ongoing collaborative relationships. And they have done so largely in the wake of the spectacular commercial success of the new 'relational model'.[19]

In some industries this focus on relational contracting between major purchasers and their suppliers has simultaneously driven costs down and quality up – often markedly. Purchasing complex sub-assemblies in the automotive industry is the paradigm example. Calzolari and

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[17] The micro-economics of purchasers of services leaving more money on the table for providers is explained in Lafontaine and Margaret E. Slade (2008 p. 28)

> A relational contract is one that is sustained on the value of future interaction between the parties. In this literature, interaction is usually modeled as a repeated game with imperfect monitoring of the agent's effort. Since the agent's actions are unobservable, contracts cannot be written on effort.. . . . However, it is assumed that effort shifts the distribution of outcomes. In particular, high effort causes good outcomes to become more likely. In that setting, if the reward to good behavior is sufficiently high, the agent will eschew cheating in favor of high effort. In the context of inter-firm contracting, this implies that the agent must earn higher than competitive rewards. In other words, he is not taken down to his reservation value. Relational-contracting models are therefore similar to efficiency wage models [in which employers pay employees more than the market clearing wage, to induce additional effort and build the relationship between employer and employee.]

[18] Interestingly Gershon (2008, p. 37) reports the same view in IT. "There was a general view that industry finds the private sector easier to do business with."

[19] See, for example, the discussion of the DuPont legal model later in this report.

Spagnolo (2009, p. 2) exemplify the contrast between the two approaches by comparing Toyota and GM's approaches within the automotive industry.

> Like many other Japanese firms, Toyota maintains a small stable set of "highly trusted" dedicated suppliers, restricts competition for orders to them alone, cares for their profitability and rewards the best performers with a larger share of orders, while it replaces those that fail to deliver the extremely high levels of contractible and non-contractible performance required. The limits to competitive screening entail the cost of reduced screening and higher prices, at least compared to GM's more competitive selection; but this approach ensures that sufficient weight is attached to future stakes and consequently guarantees a cooperative perspective in the supply relationship.[20]

As Dore observes (1983, p. 475), at least in Japan, this relational model of contracting also tends to support high levels of quality as the service provider uses this as a signal to the purchaser that he is not exploiting the privilege of the relationship.

Often public preoccupations with probity constrain the ease and extent to which government agencies can, or feel they can, pursue 'relational contracting'. The agency must comply with the CPGs which emphasise a particular interpretation of due process as it applies to competition. Thus for instance, the Guidelines emphasise that

> Competition is a key element of the Australian Government's procurement policy framework. Effective competition requires non-discrimination in procurement and the use of competitive procurement processes.[21]

Without disagreeing with the importance of these sentiments, one can see how such guidelines, or a particular interpretation of their letter and intent, might obstruct improved relationships, better quality and even lower prices from suppliers. Some of the most successful purchasers of complex inputs in the private sector have relationships with suppliers which are in effect indefinite so long as it is clear that the supplier is exercising its best endeavours and continuing to perform well and meet the purchaser's expectations (Dore, 1983). Providing they do not lock the purchaser into unsatisfactory arrangements (for they are broken if this occurs) one can appreciate the economic sense behind such

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[20] American car manufacturers have moved towards the Japanese model of purchasing since the article on which Calzolari and Spagnolo base these comments (Asanuma, 1989).

[21] Guideline 5.1. See also Guideline 5.2 on non-discrimination.

arrangements. For the service provider will often make investments that are focused particularly on the purchaser's needs and which therefore risk generating unsatisfactory returns outside the relationship with the purchaser.[22]

Yet such a contract is antithetical to the CPGs as it offers no way by which it can be demonstrated through time that the arrangement continues to be competitive – rather than, for instance, being the product of favouritism. And generally, no matter how well a particular provider may be qualified to provide a service, no matter how good their track record, there will exist situations where purchasing guidelines mandate – or are taken by many public servants to mandate – that over a certain relatively low threshold value, a provider cannot simply be awarded work, without a tender process. And tender processes are not just costly, for both parties; they are imperfect.

Those assessing the relative merits of tender bids must make fine judgements. And tenderers don't know what is in others' bids. So winning business through tenders can be a chancy affair. The best service provider may not write the best tender, or, having invested in specific assets to improve the quality with which they can service a particular need, may have that investment underrated by those assessing a tender, or be undercut by a competitor. Whilst such an outcome may generate short term gains for the Commonwealth, (though it might also represent a misjudgement in which too much quality is sacrificed for price), such improvements in costs are unlikely to be enduring (or if they are may come at the cost of lower quality) – as other firms will be unwilling to make the specific investments necessary to provide high quality service for fear of them being similarly 'stranded'.

As Lafontaine and Slade, (2008, p. 23) put it. "Specific investments give each party to a relationship a degree of monopoly or monopsony power. Indeed, even when there are many potential trading parties *ex ante*, when investments are specific, parties are locked in *ex post*." In light of these considerations, large organisations in both the public and private sectors often settle for an approach which combines elements of open tendering and periodic lock-in of buyers and sellers. Thus buyers periodically assemble 'panels' from which they commit to purchase services.

The rewards of being on the panel provides a favourable environment for the purchaser to obtain a good deal from firms eager for the preferment that the panel offers to deliver. Even if there are no benefits in projecting the purchasers market power – a matter to which we will

[22] Lafontaine and Slade, (2008, p. 23)

return – both parties can be advantaged by panel arrangements. For large organisations, and particularly government organisations, have elaborate purchasing procedures to vouchsafe the efficiency, equity and probity of each substantial purchase they make. And in establishing a panel, much of this work can be done *en masse* in advance. This enables *ad hoc* purchasing at short notice (as is often the case when an agency seeks urgent legal advice for its Minister to inform the Parliament), or in a way that is much more streamlined than would be the case without the panel having been established. To establish a panel, a tender process is conducted which involves extensive documentation, deliberation and expense for both purchaser and provider and a high degree of risk for providers. It is accordingly a source of frustration for many and an important focus of this study.

The significance and nature of the informed purchaser

Though recent commentators have not used the economic jargon of search, experience and credence goods, it is not surprising that there is broad consensus that given these difficulties arising from asymmetric information, and the importance of high quality relationships with service providers, the Commonwealth must be an *informed purchaser* to ensure it obtains value for money from legal service providers.[23] As we discuss below there is also research evidence that better informed buyers receive better service.

We agree with Blunn-Krieger that the informed purchaser must be a professional in all the senses of the word, but it is worth emphasising that the relevant knowledge comes not just from preparation and search, and not just from experience. And it may not reside in one person. (One might even go so far as to say that it *should* not reside in one person.)[24] Rather the professional informed purchaser should be understood to exist within a management system which is both knowledgeable at the

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[23] Recent reports embodying this view include two reports from the Australian National Audit Office, (2005, 2006), the Beaton Report (2006) and Blunn-Krieger Report 2009.

[24] Beaton Consulting's (2006, p. 42) interpretation of ANAO's concept is that

> An informed purchaser is an identifiable *person* within the government agency with the following attributes:
> - knowledge of the agency's 'business'
> - knowledge of the law and legal practice
> - skill in coordinating legal service arrangements
> - ability to link strategic decisions to their daily implementation
> - skill in ensuring value for money for legal services.
> - Knowledge of procurement policies, guidelines and processes
>
> [Emphasis added].

outset but which also – crucially – continually captures relevant information, processes it in useful ways and learns from experience. It is clear that the best, most informed purchasers focus very deliberately on this task. They optimise their capacity to be informed purchasers by continuously measuring how well their suppliers are performing, with most of their focus on improving future outcomes (though it is sometimes possible to revisit contracts – for instance fees paid – in the light of experience). Further, it should be understood that an insistence on the importance of information and measurement is not offered as a panacea, but rather as a crucial adjunct to what must be the ultimate determinant of agency decisions – the skilful and informed exercise of professional judgement.

But it has been understood for some time that only some Commonwealth agencies could be described as informed purchasers of legal services. The ANAO performance audit (2005, p. 15. §13) reported that:

> while some audited agencies had an 'informed purchaser', a number of agencies required improvement in this area. Similarly, there is scope for some audited agencies to improve their internal communication and their systems for monitoring and reviewing legal purchasing decisions.

It further observed that in some agencies "legal services were being purchased by staff with no knowledge of the agency's standing arrangements with external providers (including agreed rates), or any knowledge of the requirements of government policy". (2005, §3.8 p. 51.) More recently, Blunn-Krieger (2009: §126) observed similar variations in the extent to which agencies were informed purchasers.[25]

As one might expect, the problems of ensuring that purchasing is informed are least-developed among agencies with smaller legal expenditure.

[25] We have identified a small number of general counsel in Commonwealth agencies who exemplify the informed purchaser, and a number of in-house legal teams which are structured and managed to high standards of professionalism. However, it is apparent that whether an informed purchaser of legal services or a professional in-house legal practice exists within an agency depends on the skill and experience of the individual recruited into the role, rather than on any development of the informed purchaser skill by either the agency or the Commonwealth particularly with small agencies more broadly. There is within government no formal mechanism to assist in the development of these skills.

Informed purchasers have an interest in sharing information

Further, given that legal services have characteristics of both search and experience goods, there are likely to be strong synergies between the search and experience of one Commonwealth agency and that of another. If one agency does not have experience with a firm, it can become a more informed purchaser if it can share information with agencies that have. As suggested above, this will be particularly useful for smaller agencies. Yet the degree of sharing of information between commonwealth agencies is informal and patchy at best.

Successive reviews since the Tongue report (2003) have raised the issue of information sharing. However though the Office of Legal Service Coordination (OLSC) has sought to facilitate such sharing, its degree of authority and resourcing have made this difficult. Militating against OLSC's success has been the autonomy of agencies and their internal legal practices' focus on their own missions. It has also been exacerbated by the diversity of the resulting management approaches and information systems.[26]

Influencing expectations of the future and the importance of reputation

> The normal market mechanism for dealing with asymmetric information is reputation.
>
> John Kay (2003, p. 370)

We have discussed the way in which informed purchasing can protect purchasers from the perils of asymmetric information. A striking example is provided by a recent study into the purchasing of expert financial advisory services. Oehler and Kohlert (2009, p. 110) showed that expert financial advisors "put much more effort into collecting information . . . providing information, and in their recommendations" when they were aware that their clients are financially knowledgeable." Note that the protective factor here is not the informed purchaser's complaints against the financial advisor. The fore-knowledge that they were dealing with informed purchasers was sufficient to tip the scales.

And the benefits of this orientation towards the future can go far beyond this. For buyers' purchasing from a supplier that has not previously taken advantage of him is no guarantee that it will not occur in future. What

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[26] As Anthony Field (2010) has observed:

> Even across the better managed practices there are a number of quite different approaches and each has its own strengths and weaknesses.

does give some comfort that it will not occur in the future is both parties' knowledge that the other is forward looking. Thus, as Nicola Doni puts it (2006, p. 404):

> Undoubtedly, economic theory supports the opinion of Kelman (1990), according to which in a public procurement context 'the most powerful incentive is to tie future business to performance on current contracts'.

Once they are focused on the future, the parties might be described as *trust seeking*. Both parties could be said to be in what economists and game theorists call a 'prisoners' dilemma'; that is either one can benefit (at least in the short term) by taking advantage of the other.[27] Yet the prisoners' dilemma can be overcome where the game is repeated indefinitely and where the players can communicate and commit to co-operative strategies. The essence of doing so is to focus each party on the greater gains to come in the future from building a relationship of mutual service and trust between each other. As Harvey explains (2002, p. 302), "[a]ccording to the economic literature, trust can be achieved in a roundabout way through institutional and other devices that give individuals an incentive to be trustworthy".

Picci (2011, p. 6) outlines the processes by which the greater the reliability of reputation and the greater emphasis players in the market place on it, the greater support is given to further efficiency enhancing behaviour.

> By rewarding good performances, they encourage actors to invest resources in improving their skills. If professionals know they will move up the career ladder if they do well in the job, they may decide to spend evenings taking classes to learn new skills. On the other hand, if they know that all they need are good connections, then they are quite likely to spend their evenings in networking activities. One effect of the presence of reputational incentives is to curb unproductive, rent- seeking activities, as economists call them.
>
> Being able to observe past performances helps us to discriminate between high- and low- quality suppliers.. . . . Such reputational effects set in motion selection forces that weed out the least fit from the competition.

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[27] The supplier can do so by over, under servicing or by overcharging and the purchaser, if he suspects it will find it difficult to prove. The purchaser may be able to exploit the service provider by getting them to invest in relationship specific assets (personnel and expertise) and then exploit its market power as a dominant buyer of the relevant services so as to squeeze returns unfairly.

One can add as a subset of this that such processes often intensify the incentives for outstanding performance for some. Thus for instance in some well developed markets, niche players develop reputations for delivering highly desired qualities in their products and can become hugely profitable. Mercedes Benz in the automotive industry and Apple in ICT and related consumer electronics provide two cases in point. This is no less true in the labour market for lawyers.

If, as Picci puts it (2011, p. 6) "[t]he more important reputational considerations are, the more likely it is that the balance will tilt in favour of virtuous behaviour" from the service provider, then the more it can bolster the integrity of the process by which reputation gets formed, and the more it can facilitate such reputational information influencing its service providers the better. There are some promising options here, and addressing them may also assist in improving the working relationship between legal service purchasers and providers. Accordingly before elaborating them, we will turn to the quality of that relationship.

All the above being said, it is important to emphasise that both purchasers and providers have to have an eye to the bottom-line implications of their relationships — which is why purchasers wish to maintain competitive tension among suppliers, and why suppliers try to maintain 'wriggle room' in their charging (e.g. by agreeing hourly rates but without necessarily being tied down in terms of the number of hours a particular piece of work might take).

III. Adam Smith and the optimisation of mutual interest: relational contracting and agency panels

> Collaboration requires effort, and it also requires a change of mindset. In particular it requires a willingness to examine services from a perspective which does not place one's own institution at the centre.
>
> Warwick Cathro, in Holley, 2010.

As suggested above, because legal services are a search, experience and credence good they are also a 'relationship' good. The purchaser and the provider will often need to work together closely and the quality of this relationship – even the personal 'chemistry' of important officers from the purchaser and provider agencies – will also be of considerable importance to the ultimate outcome.[28] And if organisations are sufficiently well managed such professional relationships can sometimes survive personnel turnover.

Representatives of private firms emphasised that good price and quality does not come from attempts to squeeze every last drop out of the price. Of course, like the better private clients, all buyers will try to get the best price. But mindful of quality and of their *long term* interest, they will also understand that the best results will come from some balance between competitive tension and suppliers feeling sufficiently assured of ongoing work to enable them to invest in the relationship specific skills necessary to deliver better service and value for money.

Existing relations between major purchasers of legal services and service providers are reasonably good, as one would expect given the competitive interest the parties – particularly the service providers – have in good relations. Even so, one of the striking aspects of our consultations was the frustrations of private sector firms in dealing with their Commonwealth clients.

A plethora of practices do not just irritate, but degrade the economic efficiency of tendering and so the critical process of selecting the best service provider. The problems are often associated with what Blunn and

[28] Indeed, a number of participants in our consultations suggested that private sector tendering of legal services focused more intensely on the quality of relationships than public sector tendering, and (in the opinion of legal service providers) as a result the quality of the relationships was generally superior in service provision arrangements with large private sector purchasers.

Krieger (2009, §125) diagnose as a tendency to over-rely on process in purchasing. Agencies' interpretation of the Commonwealth Purchasing Guidelines (CGPs), has created a default procedure which fails to emphasise what is most important about optimising value for money – which is informed purchasing, and the establishment of relationships of collaboration between purchaser and provider.

It is imperative that that relationship also be conditioned by strong competition between providers – which is a major theme of the GPGs. But value for money cannot be vouchsafed by simply adopting by default procedures that have become accepted practice. Agencies require legal services, often urgently, but to purchase them creates a 'purchasing event' which must be made to comply with the CPGs. Agencies feel the need to already have arrangements in place which ensure that an urgent purchase is compliant.

Overwhelmingly the have adopted the following procedure:

- Each agency with any volume of legal services purchasing establishes a panel of service providers through an extensive pre-qualification process. This involves an open, competitive tender ranging over price – typically conveyed in dollars per hour – the setting out of the agencies legal needs to which the providers respond with details about their capabilities, key performance indicators (KPIs), the terms of a deed of standing offer that providers selected for the panel agree to and so on. The relevant documents take many months and the expenditure of tens if not hundreds of thousands of dollars by both the agency and firms seeking selection to the panel.

- Selected firms then provide the bulk of legal services. There may be 'sub-panels' for specialist work and 'mini-tenders' or competitive quotations for particular pieces of work to promote in-panel competition.

- The panel runs for a period of time – typically three years – with provision for extensions at agencies' option.

Agencies' gravitation towards this model is not primarily motivated by optimising value for money, though it is hoped that the prize of access to the panel will intensify competition on price between firms (mostly in the form of lower hourly rates). Rather the *establishment* of the panel is deemed the relevant 'purchasing event' under the CPGs and so, providing this process is meticulously documented and run, agencies are

then free to contract with panel firms, including for 'covered purchases' over $80,000 without further formalities.[29]

Yet despite – or perhaps because of – the appearance they give of intensifying competition – much of the way panels work frustrates the optimisation of relationships between purchasers and providers. In this regard, it is worth considering the pitfalls of the Commonwealth pursuing its own self-interest in too narrow, short-sighted a way. Indeed this was the true import of Adam Smith's original thinking about self interest nearly a quarter of a millennium ago. Smith (1776, Book 1, Chapter II) famously observed:

> It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own self-interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.

This passage has routinely been taken – by economists and non-economists alike – to endorse not just the private, but also the social good that will arise from people looking exclusively to their own self-interest in their interactions with others – at least in markets. In fact Smith's point was a subtler one – that neither party can serve their own interest at all well without understanding and meeting *the other's*.[30]

In this context the market is not some *deus ex machina* aggregating self-interest to somehow optimise economic welfare. It is an institution by which parties come into relation with each other, learn of each others' respective interests, thus enabling them to optimise their *mutual interest*. By the same token, too crude an application of the Commonwealth's self-interest will perversely harm that interest. It is easy for tenderers to ask for more from providers; more information in tenders, more copies of

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[29] Of course with matters of this size agencies often issue requests for quotations or tender large jobs, notwithstanding their ability to go to a panel, something they do both to further 'cover themselves' from potential controversy and also, because, providing they are sufficiently streamlined, they offer a useful means of obtaining value for money, even given the panel.

[30] As Smith put it (1763, Tuesday. March. 29) during the long gestation of *The Wealth of Nations* quoted above:

> Man continually standing in need of the assistance of others, must fall upon some means to procure their help. This he does not merely by coaxing and courting; he does not expect it unless he can turn it to your advantage or make it appear to be so. *Mere self-love is not sufficient for it, till he applies it in some way to your self-love.* A bargain does this in the easiest manner. When you apply to a brewer or butcher for beer of for beef you do not explain to him how much you stand in need of these, but how much it would be in [his] interest to allow you to have them for a certain price. (emphasis added).

tender documents. It is easy for agencies to tender for a panel through a tendering process that is expensive for firms to participate in, and then leave so many firms on its panel that most will fail to win a reasonable amount of work. The former practices above act as little more than minor irritants to relationships with potential service providers, but the last example sufficiently increases risks for service providers that it could see firms stay out of tenders and so risk substantially diminishing competitive pressure in the market.

Failing to consider the others' interests in the bargain can initially trap service providers into invidious situations which generate advantages for the buyer. But the Commonwealth is likely to pay in the form of lower quality or higher prices over time. Often this will be not be apparent to the Commonwealth – it may not be the withdrawal of a firm so much as a highly prized lawyer within one of the firms whose skills are redeployed, or a lower priority given to tendering for the next job. And how is the Commonwealth to know how vigorous competition would have been if the tendering process better reflected service providers needs?

In fact some national legal services firms have withdrawn from the Canberra market. In its submission to the Blunn-Krieger Review, Deacons (2009, p. 2) conveyed its concern about the difficulty of servicing the Commonwealth market:

> We are concerned at the current disincentives to participation in the Commonwealth Government legal market. Current Commonwealth Government legal panel arrangements are dominated by the same four large private legal firms and AGS. . . . . Many firms, such as Freehills, Allens and Corrs, have closed their Canberra offices, demonstrating that the Government market is too complex and stifling.

It is worth recognising that the Commonwealth and its service providers' interests are much more aligned than a simple understanding of their respective self-interest might suggest. Their interests clearly diverge regarding the price paid for services and the quality of those services (where higher quality generates higher costs, which to the surprise of some, is not always the case). But beyond this, the Commonwealth and its providers' interests largely coincide. Which means the Commonwealth should consider the interests of its providers just as much as its own direct interests. For by so doing it can assist those providers to supply it with the best product they can – at a price which informed purchasing in a properly managed market should ensure is the best reasonably attainable.

A central objective of providers is to secure a reliable stream of work and this is something they are prepared to bid aggressively for (See Box 1). Often this is a justification for the establishment of panels – creating a class of providers that have earned the right to preference by bidding in an open tender. Yet as currently structured, panel arrangements are far from

sufficient as a means of delivering such security. In principle, in tendering for a panel, a firm could offer a pricing formula that rewarded the agency with lower prices for a steady stream of business.[31] But this would complicate their offer. And it is unlikely that a mechanically expressed pricing formula could be specified in advance that would be able to operate throughout the term of the panel's existence to match the evolving needs of both purchaser and provider(s). Of course, having the inside running on a panel is advantageous, but it can be a far cry from security of volume for a firm, which is only likely to emerge (if it does at all) from the relationship that grows from their presence on a panel.

[31] Note also that panels typically constrain firms' prices with ceilings on hourly rates. Presumably this assists agencies in keeping costs down, but it determines only one aspect of the ultimate price. Some General Counsels felt that a binding commitment on hourly rates was "just the beginning" in ensuring cost control. (Likewise in a ACLA/CLANZ survey buyers of legal services from corporates and government agencies rated overall value much more highly than hourly rates (Stock, 2008).)

Box 1: Richard Stock on informed purchasing to maximise buying power

There have been tons written about the need for convergence in the number of firms. But here are my observations built on experience negotiating deals.

1. I start with a 10% discount when paying a firm $500K per year

2. It is difficult to get more than 15% reduction in hourly rates until annual fees exceed $2M for the firm. Beyond this a reduction in the "effective rate" can be introduced as per my Hybrid Fee Arrangement.

3. I have obtained 25% discounts on all standard rates by giving a firm a combination of large volumes and duration of legal services, i.e. a 3-year agreement in the $6M range.

4. Great care is needed to ensure that all annual rate escalations and office disbursements are built into the arrangement with the firm. This is to avoid being nibbled to death as time goes on.

5. Law firms have a strategic interest in doing work that allows them to service a client with the firm's other offices (so outside their usual service area) or which helps them diversify the specialties the firm is delivering to a client. This allows the firm to create ties that bind them in many different ways to a client. My experience is that this translates into yet another layer of discounts in overall pricing.

6. Giving a firm 20,000 hours per year as a baseline opens the door to very interesting AFAs [alternative fee arrangements] especially thinking of 3 year arrangements. I have negotiated a 40 month arrangement with a national firm where the volume was 44,000 hours per year of medium to highly complex professional liability defense work in the medical sector. Huge interest and leverage.

Personal communication from Richard Stock: Principal, Catalyst Consulting and the Australian Corporate Lawyers Association's preferred provider for legal department consulting.

Accordingly, if the Commonwealth were seeking to obtain better terms from service providers it's main avenue to doing so would not be by seeking to depress their profits (although there is a case for seeking to use what buying power the Commonwealth has) but rather by trying to work out ways that it can collaborate with service providers so that each gains by more than they do now. It is possible that panel arrangements assist some purchasers in obtaining better deals from service providers than would otherwise be the case, but it is likely that really skilful and informed purchasers could do better still outside of panels by working out how they could give their service providers things they value, like more security, consistency, flexibility of workload or risk sharing. Of course it is likely that many of these things come at some cost to the

agency. The question is not how can the agency minimise its own cost by imposing costs upon the provider, but rather, how can it

1) discover how it and its provider can best meet their *mutual* needs so as to minimise their joint costs and then

2) bargain to share the benefits of doing so.

This is why collaboration between the purchaser and the provider is central to each optimising the value it gets from the relationship, a subject to which we turn subsequently.

IV. Where the gains are

In this section, we distinguish here between three areas of action:

1. Reducing tendering costs
2. Better exploiting Commonwealth buying power and
3. Enhancing the Commonwealth's capabilities as an informed purchaser and improving the productivity of the relationship with service providers.

In elaborating the first two of these areas we explore the benefits that might be captured by moving from the current decentralised system to a more centralised one. For the purposes of exposition the comparison we have in mind is between the *status quo* and the most centralised of the options under consideration – a central panel from which agencies manage their own purchases. As will become evident below, virtually all the important issues in managing the purchasing of legal services are subtly interrelated. Accordingly the temporary separation of the issues and the models of tendering pursued here is relaxed in subsequent sections. However, there is merit in temporarily separating the issues to focus on their intrinsic qualities. This is done in the three sub-sections below under sub-headings that correspond to the three-item list above.

Reducing tendering costs

It is clear that substantial resources are tied up in tendering. As a proportion of total expenditure on professional fees for legal services to FMA and CAC agencies, the proportional figure is estimated at 3.85 per cent (Appendix A). Lateral Economics asked both purchasers (government agencies) and providers of legal services (private law firms and AGS) about the significance of tendering costs in the demand for and supply of legal services via a survey circulated in January 2011. Although large firms were well represented in survey responses, estimates for smaller firms had to be based on relatively few responses. Further, estimates varied substantially (we suspect because of very different methodologies in estimating costs). Some providers and some agencies appeared to go to some trouble to fully cost the resources used in tendering whilst it seems likely that others reported incremental costs.

Purchaser tendering costs

Agencies' costs of establishing a panel averaged $120,000 (though some estimates seemed unreasonably low). Thus there was considerable variation around the average, reflecting significant

variability in the amount of work panel firms would be approached to undertake in a year as part of the Commonwealth's external legal services spend, as well as the methodologies used to report costs. Nevertheless as documented in the appendix, our estimates tend not to be far out of line with similar exercises.

This implies a total cost of around $8.6 million to set up 72 panels. If we assume these panels last for four years each, around $1 billion dollars of legal services will be bought through them, bringing the cost of establishing panels down to 0.86 per cent of the value purchased through the panels. An alternative estimate of agency costs as a proportion of work done by the resulting panels calculated in Appendix A is around 0.85 per cent.

Provider tendering costs

To this we need to add the costs incurred by panel firms in tendering for panels. Provider costs of bidding to be on panels ranged from $2,500 to over $150,000 with the average around the $10,000 mark. Again, there was considerable variation around the average, reflecting significant variations in costing methodologies and variability in the complexity of material provided in tender documents.

And with some panels attracting 20 bids or more,[32] such panels would involve providers incurring over $200,000 in bidding costs.[33] However, the average provider cost per panel could be expected to be significantly lower that this figure, estimated to be of the order of $100,000 (in round figures), or some $7.2 million to establish 72 panels.

To put these estimates in perspective, the Victorian Department of Justice estimated provider tendering costs between $100,000 and $350,000 (depending on the number of panels firms chose to tender for). So six-figure amounts in terms of provider costs — either in terms of overall bidding costs for panel formation or in terms of bidding costs to get on panels on the part of some firms — would not be unusual in the case of larger law firms wishing to supply legal services to governments in volume.

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[32] We were advised, for example, that one panel for around $5 million per annum attracted 19 bids while another for around $15 million of work annually drew 25 bids. Other examples suggested that, other things equal, the more work was on offer the greater the number of bids likely to be forthcoming (see also following footnote).

[33] However, the number of responses tenders for panels are likely to elicit can be constrained by criteria incorporated into tender documents (e.g. requirements that bidding firms be not only full-service but have an office in Canberra). Thus, although high-value panels could be expected to attract high numbers of bidders, this may not necessarily be the case.

Estimated provider costs as a proportion of work done by the resulting panels worked out at around 1.4 per cent in the case of large, full-service firms (with this estimated weighted to reflect the 89 per cent market share enjoyed by the top 10 firms). However, the contribution from smaller firms to an overall estimate of tendering costs in relation to work done in a year was higher (at 1.6 per cent — with this component again weighted to reflect the 11 per cent market share accounted for firms outside the top ten firms). Adding together the two components produced an estimate of 3 per cent as the equivalent provider tendering cost represent of the value of panel work commissioned by the Commonwealth annually.[34]

Combining this estimate with the 0.85 per cent estimate for agency costs yields an estimate of $9.8 million per year or 3.85 per cent when tendering costs are expressed as a proportion of panel work available annually. Then there are the additional 'mini-tenders' run by agencies within (and outside) panels for large or special (e.g. one-off) pieces of work, which on the basis of available survey-based information could add another $2.5 million to overall tendering costs (or 1 per cent as a proportion of the estimated $255 million of panel-related work available annually from the Commonwealth).[35]

Each of the proposals for change in Blunn-Krieger involved some intended rationalisation of tendering at least for panels. A central panel would reduce substantially the expenditure involved in panels. If all the panels could be replaced with more centralised arrangements – whether using panels, multi-use list(s) or a mix of the two, the process for selecting the central panel would be substantially more elaborate than the process of selecting a panel for a particular agency. [36] At the very least the central panel is likely to have various sub-panels which would increase tendering costs over and above most individual panels. Later in this report we suggest subject area panels and a multi-use list to replace

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[34] For this exercise we assumed that firms' tendering costs relative to the dollars they earned tended to reflect their market share rather than their size. Of the 11 per cent of revenue earned by firms below those itemised in the OLSC report around half was earned by firms with more than 200 employees. However the revenue earned per firm was much lower than the market leaders, which is likely to have driven up tendering costs as a proportion of revenue earned.

[35] Note, we suspect that firms may have underestimated their costs in this regard. Given the time constraints we were under, we did not pursue this matter further as there were no proposals under consideration that would have changed the extent of these costs in any systematic way.

[36] This observation is based on common sense, we have seen the costings of one agency which costs the establishment of a central panel at around twice the cost of establishing an agency panel.

agency panels which we suggest would reduce tendering costs by between 50 and 75 per cent. We do not favour a single central panel because of some risks it raises as outlined in the next chapter. However it should be acknowledged that it could reduce tendering costs slightly more than subject area panels. A sensible range for this figure would be between 60 and 85 per cent amounting to around $6 to $8.5 million annually.[37]

Better exploiting Commonwealth buying power

If legal services were a homogenous commodity – like wheat of a certain grade – it would follow that any monopsony power the Commonwealth currently exercises in its buying is extremely small to negligible. This follows quite logically from the fact that reforms since the Logan Report have completely dismantled the capacity of the Commonwealth to centralise its external purchases of legal services. Since many agencies purchase legal services independently of each other, they compete with each other and in so doing undermine any monopsony power that the Commonwealth might have in the market.

A range of other theoretical and practical considerations would suggest that the Commonwealth's market power is limited. Certainly if it were possible for the Commonwealth to exercise market power allowing even ten agencies to compete for it ought to compete away most of any monopsony rent that might be available, let alone 72. Further, if market power existed one might expect that more agencies would be tempted to piggy back on each others' arrangements – to combine their buying power.

If panels allowed agencies to drive prices down without sacrificing quality, one would expect that it would be common for other agencies to opt into (piggy-back on) those arrangements if given the option. Yet apart from the 'family' arrangements whereby smaller agencies opt into their portfolio departments' panel arrangements more wide-scale piggy backing seems rare.[38]

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[37] A simple calculation assuming that a central panel would cost three times as much as a normal panel to establish would yield a saving of nearly 96 per cent. However it seems likely that some agencies would engage in additional selection processes which would have resource costs both for them and tor firms. Accordingly we have pulled our guestimates back somewhat.

[38] Agencies are not required to inform OLSC of piggy backing arrangements however so there is no central source of information on the extent of piggy-backing. It should also be noted that the policy on piggy-backing as expressed in the common form tender documents is that it should occur within a portfolio rather than across portfolios. However, even leaving this aside, the OLSC believes that an important constraint on the spread of piggy-backing has been that panels have not typically been set up with this in mind. This has meant that

Box 2: Opting into the central panel in Victoria

[T]he Legal Services Panel is classed as a State Purchase Contract which means that its use is mandatory for all government departments (11 of them) and a number of Administrative offices eg. Victorian Electoral Commission, Office of the Privacy Commissioner.

Statutory Bodies and State Owned entities can opt into the panel contract. Once they have opted into the panel Contract they must then use the panel firms exclusively for all legal work unless carved out as part of the opting in arrangements. Currently there are 13 Statutory Bodies on the panel. . . . [T]here are over 2000 Statutory Bodies and State Owned Entities.

The Statutory Bodies that have opted into the panel contract make up between 5% to 8% of the total expenditure. . . . VicRoads only recently joined the panel and it is anticipated their annual spend on legal services is between $5m to $7m. This will have an impact on the percentage of the total expenditure, pushing it up to 10%.

Source: Lateral Economics correspondence with Victorian Government

However closer inspection reveals that neither the Commonwealth nor Victoria offer a particularly good test of the attractiveness of piggy-backing. In the former case piggy-backing has mainly been used within portfolios where there appears to have been substantial piggy-backing. Because piggy-backing was not intended to be common across portfolios, departments that have sought piggy backing arrangements across portfolios report nearly as much trouble in doing so as setting up their own panel. Thus for instance at the Commonwealth level, piggy backing across portfolios typically requires service providers on the panel agreeing to extend the terms of the panel to piggy-backing agencies, something they sometimes refuse to do.

Victoria has the makings of a more compelling experiment. It runs a central panel and requires panel members to provide its independent statutory bodies with the right to opt into the panel arrangements and terms. Yet take-up has been modest (see box). Perhaps such agencies are loath to compromise their autonomy and their existing relationships. But the central panel has been running since 1 July 2002. Some would say that, given the existence of the panel Victorian Government agencies can approach a firm on the panel and negotiate similar terms to the panel.

piggy-backing arrangements can be quite cumbersome. The OLSC is optimistic that, if the desirability of piggy-backing were more fully taken into account in the establishment of panels, piggy-backing might be substantially more popular.

However to 'opt into' the panel, agencies become bound by the requirements of line agencies using the panel which is to say that they must accept it as an exclusive arrangement, constraining their freedom to purchase from outside the panel. This is likely to concern some of the potential candidates for opting in. In addition it is thought that the existence of the right to opt in may give them the ability to negotiate similar terms with participating firms, obviating the attractions of formal membership of the panel with its constraints.

Nevertheless it is well established in the literature that large firms in such markets tend to both buy and sell well. Large firms in professional services like law, auditing and accounting tend to price at higher levels than smaller firms, typically apply higher mark-ups to the charge-out rates of staff and also offer larger buyers better prices than smaller buyers. Certainly there is evidence from professional services markets that large firms charge a premium for their size, the prestige of their brand and the wide range of the services they provide both by subject area and by location. And there is evidence that larger buyers tend to get lower prices (McMeeking et al, 2007, p 311, Francis and Stokes, 1986, pp 385-386).

Given this we consider it likely that if the Commonwealth were to be able to rationalise and co-ordinate its purchases better, it could achieve better prices. There is little doubt that the risks service providers feel they incur in tendering for a panel are substantial. At present the top three agencies' average spending on legal services is over $50 million per year, a large market for the legal practices' investment in their Canberra offices (from which the demand is met disproportionately), even though Commonwealth work does not generally account for a large share of the main firms' national revenues. The larger panels are, the more this risk is increased improving the chances that firms will 'sharpen their pencils'.

Currently, projecting buying power is not agencies' central motivation in establishing panels. Agencies indicated that their dominant motive was to front-load compliance with the CPGs to enable them to manage procurement more smoothly, if needs be quickly, and flexibly once the panel had been established than would otherwise be possible.[39]

There are some risks in seeking to project market power. To maximise market power all Commonwealth purchasing would need to be

[39] This dominant motive is also reflected in the Department of Finance's (2007) Good Procurement Practice booklet *Establishing and Using Panels.* It provides three "reasons for establishing a panel" (§3.3-5). Each of the three paragraphs of the guide reference such things as expedition and flexibility as a motive, one exclusively, whilst efficiency and competitive pressure are mentioned as part of the motive in two paragraphs. http://www.finance.gov.au/publications/good-procurement-practice/04-establishing-and-using-panels.html

controlled by a single entity. This is likely to compromise quality. However, where demand for services was focused on specific subjects this would firstly aggregate demand to a substantial degree giving firms a strong incentive to quality for the panel. Secondly this would be particularly true for firms which were particularly focused on those areas. This is one of our reasons for recommending subject area panels which we see as capturing a range of benefits whilst minimising the costs of a central panel. We've tried to finesse these things in our recommendations – with some substantial rationalisation of panels, but not a wholly central panel.

Our soundings in industry and reading of the literature suggest that discounts of the order of 20 per cent are available to large buyers. Given this, we think it conservative to suggest that, should the Commonwealth be able to focus its purchases in a more coherent way, the improvement in the projection of its buying power would likely enable it to achieve improvements in the terms on which it buys services of the order of 2½ to 4 per cent or somewhere between $6.5 and $10 million dollars per annum.

Enhancing the Commonwealth's capabilities as an informed purchaser and improving the relationship with service providers

All recent substantial investigations into the external purchasing of legal services of which we are aware have highlighted the priority of improving the Commonwealth's capability to become an informed purchaser. This is not surprising given the highly individualised nature of legal services contracting. We are unaware of any systematic studies which demonstrate this conclusively, but virtually all the big 'success stories' of which we are aware of controlling legal costs whilst maintaining or improving quality revolve around measures buyers have taken to finesse their relationships with suppliers. Further all the general counsel to whom we spoke stressed the importance of informed purchasing to drive costs down and quality up.

This involves a range of attributes including;

- being very clear with service providers in communicating what is expected (e.g. poorly drafted briefs can lead to responses which are not business relevant and which may require additional work after the brief has been clarified);
- the purchaser informing themself not just about the firm they are dealing with and other firms that are available that might do the work but also 'looking inside' the firms and knowing the qualities of individual lawyers working within them;
- building the providers' trust that the purchaser is well informed and so will recognise the quality of work done;

- responding firmly where there are problems of quality or cost, including ensuring that work is done at appropriate levels of seniority and cost within firms – so that work is not billed at a higher rate than necessary;
- being able to compare the performance of different providers – both between firms and within them – over diverse dimensions of price and quality;
- continually refining the relationship through feedback in both directions between purchaser and provider.

Box 3: Informed purchasing lowering costs

When referring to a good relationship with the firms as being a key driver behind cost performance, I was referring to our close and ongoing monitoring of performance and performance trends across all firms, which are fed back to the firms as part of their regular performance reviews . . . .

The firms are aware that the statistics on cost and quality that we keep are used by us to allocate matters and to change the percentage of matters allocated to a firm for a period. Whilst firms do not receive detailed information about their competitors, we do give them general feedback as to their ranking against the [Key Performance Indicators] KPIs in a particular period (eg firm x may be told they are the cheapest in NSW but 2nd cheapest in Melbourne, with the cheapest firm starting to create a significant gap). If we are concerned with the "gap" (eg if there is no reason, having regard to the profile of the matters allocated to firm x or the quality of their services, why they should be more expensive) we will warn firm x that it may form the basis of a re-allocation at the next review if not addressed.

There needs to be a strong relationship and high levels of trust between an agency and the panel firms to have this kind of "frank and robust" discussion and for the firms to respond positively to it. In my view, the firms need to respect that the agency knows its business (and theirs) so that the firms know that the agency is not making unreasonable demands or giving misplaced interpretations of the KPIs it is assessing and which form the basis of the re-allocations.

Any of our firms can pick up a matter on any facet of . . . our core business . . . because of the breadth of knowledge we have given them via this form of allocation process. We . . . are also in a good position, through years of experience managing our panel and regularly analysing their performance, to know and compare the levels of expertise of the firms/individuals within the firms and their areas of relative strength and weakness. We also have the flexibility to allocate more or less or nothing to a firm, depending on our assessment of their performance.

Jackie Davis, AS Litigation and Opinions Branch Department of Immigration and Citizenship, which has been very successful in bearing down on costs

The Canadian analyst Richard Stock of Catalyst Consulting who has done extensive work in for Australia's Corporate Lawyers Association (ACLA) and other Australian clients observes that often relatively junior lawyers begin doing certain types of work for clients and because a level of comfort develops between those lawyers and clients they will continue to do the same kind of work whilst their rates rise as they become more senior within the same firm. Stock argues that it is common for around

twenty percent of the work firms do to be done at too high a level.[40] (See also Box 1 of this report), Other consultancies working in the area in Australia such as Beaton Consulting in Victoria and AllyGroup in NSW also stress the central importance of informed purchasing.

It is also at the heart of the widely admired DuPont Legal Model which focuses on informed purchasing and has gained a reputation for effectively and efficiently outsourcing legal services. It has grown from a cost-cutting initiative to serve as an integrated approach "for managing change within the law department and for continuously improving how legal services are provided to DuPont business clients in terms of quality, cost and efficiency" (DuPont 2005:1).

It cut the number of legal services providers from 350 to 34 plus 4 paralegal support providers while achieving total cost savings in the first three years of $US13.2 million (as well as subsequently) enabling a 23 per cent increase in savings in one year (2005:7). Other benefits have included better forecasting of staff needs, better leveraging of purchasing power, more diverse representation and a better distribution of work.

[40] http://www.catalystlegal.com/Articles/August_18_National_Post.htm.

Box 4: DuPont Legal Model

The initial impetus for the DuPont Legal Model was the need to reduce the burgeoning costs of legal services. Core elements of the model are its:

- Business focus (with an emphasis on disciplined work processes and risk-sharing to strategic partnering and convergence).
- Strategic partnering which emphasises long-term relationships based on mutual trust, sharing of risks and rewards, working collaboratively towards common objectives.
- Ongoing reengineering of work processes (taking a more strategic or systems approach emphasising process, consistency and discipline, rather than on managing cases individually).
- Embracing of appropriate collaborative and communication technologies (which increase efficiency and improve results via use of tools to enable things like electronic invoicing, integrated matter management, electronic discovery and document imaging).
- Emphasis on efficiency and cost-control on the part of both purchaser and providers via a shared culture of efficiency in the way all parties practice law (with an eye to the bottom line).

Elements added subsequently (and incorporated into its core elements) have included:

- Performance metrics (e.g. to satisfy clients who want meaningful data that compares year-to-year performance in areas such as costs, hourly rates and staffing — both internal and external (DuPont 2005:58));
- Practice groups organised around substantive areas of practice;
- Six Sigma (a set of tools that help design, correct or optimise how a department works — see DuPont 2005:Chapter 12 for details));
- Preventive law (with its emphasis on anticipation rather than reaction); and
- Strategic case assessment (analogous to triage in health care);

Source: DuPont 2005.

V. Assessing the models on offer

The Blunn-Krieger Report sketched out three alternative architectures for legal purchasing within Commonwealth agencies. Along with the *status quo*, they are considered in this section.

A central panel replaces current arrangements

The costs of establishing a central panel would substantially exceed the costs of establishing an individual agency panel. There would be a great deal of work to be done in preparing the tender, itemising agencies' requirements. It would also be an immense undertaking for firms. In each case itemisations for previous agency-specific panels would be the raw material which would be brought up to date, and rationalised into a single set of specifications for the Commonwealth and capabilities for the providers.

If the panel were not to become a major barrier to entry for smaller more specialised firms, it is likely either that it would contain members that had some skills but not others sought of panel members, or that there would be a range of speciality 'sub-panels' as there are in Victoria. Thus one highly complex process would replace what are often quite complex processes to establish agency panels, which processes are currently multiplied by a factor of seventy as individual agency panels are established.

We have suggested above that this would substantial rationalise total tendering costs perhaps by amounts of the order of 60 to 85 per cent. On the other hand a central panel would represent a substantial overlay on agencies' practices and would likely exclude some providers with which at least some agencies work well with. The process of applying to be on a central panel could be daunting to a smaller more specialised firm capable of developing close and productive relations with specific Commonwealth agencies. One smaller firm estimated the work to comply with a tender to get on a panel of a smaller agency at an opportunity cost of $40,000 when compared with alternative uses of staff time. Complying with a single central panel arrangement could be far more daunting than that, with smaller firms feeling commensurately unlikely to qualify if they did make the effort to tender.

It would also be an obstacle to dynamism in the market. Thus if a central panel were to operate for a period of three years, and then have two one year options for extension as is common, a period of five years could pass before another opportunity to participate on the panel arose. We are aware of one panel which, given the options available to extent it, could last as long as nine years.

This could have a deleterious impact on quality and competitive tension within the panel and so on value for money. For this reason we consider this option the least attractive of the options we have considered. It would lower the costs of panel establishment, very probably considerably, but it would do so at the risk of reducing competitive pressure as outlined in the previous two paragraphs which could offset and indeed outweigh any benefits.

A multi-use list replaces current arrangements

A multi-use list could be established so that the vetting of basic requirements to provide the Commonwealth with legal services could be managed centrally, by the Attorney-General's Department or its nominee. The requirements to be on the list could be basic information about business location, structure, insurance, educational and practice qualifications and so on. This would reduce the multiple handling of such details that would otherwise be necessary by each agency. And once on the list firms would be qualified to provide services to the Commonwealth.

Table 1: No of firms it is necessary to approach to qualify with CPGs

Type of arrangement	Individual purchases > $80,000	Individual purchases < $80,000
Panel	1	1
Multi-use list	Select tender (which need not go beyond one firm)	1
No prior arrangement	Open tender	1 (with some exercise of due diligence)

Box 5: Multi-use lists and panels

Panels and multi-use lists are both lists of qualified service providers. However where firms have qualified for a panel, they have been through an exhaustive process of due diligence according to which they have been selected as the most appropriate firms with which the agency should do business. Being on a panel is in itself a 'purchasing event' under the CPGs and so the process must be simultaneously open and an exercise in skill in assessing the relative value for money offered by firms to be on the panel.

Panels come into existence as a deed of standing offer [41] between agency and firms on the panel. Finance's Good Procurement Practice [42] § 3.7 specifies that a panel exist for a set period of time (though the agency may reserve to itself the option of finite extensions to this period). For the duration of the panel's existence unless a firm's service is unsatisfactory, no firms fall off the panel and none are invited to join.

By contrast, a multi-use list itemises providers that have demonstrated that they meet certain threshold characteristics that the Commonwealth may require to be meet. To qualify for the list aspiring providers pass threshold tests, such as demonstrating their qualifications and experience (e.g. in a particular area of the law), financial viability and being suitably insured (e.g. for public liability and professional indemnity). Yet they do not 'compete' against each other or get assessed for the relative value for money they can offer. Thus, qualification for the list is much more straightforward.

Yet once a multi-use list is in place much of the administrative detail of contracting has been done. The practical arrangements within a multi-use list for an agency can resemble those it has with a panel. It can approach a single firm on the list to perform work for less than $80,000 or can perform a select tender for work over that threshold – just as it could with a panel. All this can be done without the enormous amount of work required to establish a panel. Skilful use of multi-use lists thus offer a means by which purchasing can be streamlined and the efforts of agencies to obtain good value for money can be focused on specific projects rather than the much more difficult and general judgements that must be made in choosing between firms to establish a panel.

One source of concern for agencies will be that a multi-use list cannot provide detailed pre-qualification on capability subject by subject, and nor, on its own, can it determine value for money under the CPGs. OLSC advises that it can provide detailed pre-qualification on capability

[41] See for instance the Standard Deed of Standing Offer provided by AGD accessed at http://www.ag.gov.au/www/agd/rwpattach.nsf/VAP/(A96D9A49EA98CFE780B96F6EE5A027F4)~Deed+of+Standing+Offer+-+revised+March+2009.pdf/$file/Deed+of+Standing+Offer+-+revised+March+2009.pdf on 16th January 2001.

[42] Available at http://www.finance.gov.au/publications/good-procurement-practice/04-establishing-and-using-panels.html

subject by subject – so while it would not be a complete value for money assessment, it would address one of the most costly parts of the process of establishing panels, which is the alignment of agency needs with supplier capabilities.

We have our doubts as to how much more effectively a panel tender could perform these functions. It can do so on paper with elaborate statements of capabilities and documentation of previous experience. But as argued more generally in this report, the best proof of most legal services puddings is in the eating. That is, an agency which is an informed purchaser will have a better idea of the relative capabilities and value for money of different suppliers from its *ex post* experience (or the *ex post* experience of other agencies that it has accessed) than it will get from a tender document specifying these things *ex ante*. And where there have been no such dealings with the agency, or a firm with which an agency has an existing arrangement is in contemplation for new kinds of work, it will often make better sense to seek to clarify the skills of the firm with particular projects in mind. Further where there is limited experience, it will often be prudent to gradually try out a new provider than to commit to them for a period of years on the basis of their tender documentation and references alone. One might add that new needs arise and it may not be possible to anticipate them when a panel is being established.

If successfully implemented, this option would thus reduce the administrative costs of agency tendering for panels and save the best part of the millions of dollars it costs agencies and firms to establish agency panels. However before doing so it is important to understand possible agency reactions to a multi-use list. As Blunn-Krieger reports, one of the central drivers behind the establishment of many panels is agencies' perception that an open tender to establish a panel is a safe way to ensure compliance with the CPGs (2009, p. 50, § 150).

When deciding which buyers to use on a multi-use list, agencies would need an additional mechanism for selecting their suppliers. It appears that agencies are nervous of developing close relationships of regular use with firms without some open tender. The Department of Finance and the Attorney-General's Department do not agree with this view.

We agree with the Departments of the Attorney-General and Finance on these matters. However whether their view can prevail over the concerns and practices of other agencies is not something that Lateral Economics can determine. But proceeding with a pure multi-use list is the most ambitious test of this view, and the most likely to induce the countervailing tendency amongst agencies to replicate their own costly selection processes within the centrally provided multi-use list.

There is a further possible problem. Where an agency is not a well informed purchaser, the very act of tendering for a panel does at least involve a thorough process of scoping their own legal needs, and vetting the legal capabilities of potential service providers. Though this does not of itself make them informed purchasers, we expect it often would improve the extent to which an agency that is not well informed comes to inform itself a little better as a purchaser.

Given this, an immediate move towards a pure multi-use list system on its own could lead to costs in less-informed purchasing which would offset or even outweigh the administrative costs to which it would give rise. We think a pure multi-use list approach is probably one to aim for over time and our recommendations provide a means by which one could move towards that goal. It might work today with agencies which can be relied on to be informed purchasers. If all agencies were informed purchasers it would stand to save around 3.85% being our estimate of the total annual costs of establishing panels. However given the existence of agencies that are not informed purchasers, fully transitioning to a situation without panels may also be the riskiest option.

Blunn-Krieger's hybrid model: a central panel with multi-use list

Blunn-Krieger propose that a central panel of firms that could address the broad legal needs of agencies be established. There would then be a multi-use list from which agencies could arrange service from other providers. Establishing the central panel would, as Blunn-Krieger indicate, favour large firms who could 'cover the field' for Commonwealth agencies. Blunn-Krieger appear to have in mind that the establishment of the panel would centrally rationalise a range of issues that are normally specified in agency panel arrangements such as reporting requirements, KPIs, ownership of intellectual property and so on.

The risk is that agencies, particularly those that are not particularly informed purchasers, come to view purchases from the central panel as compliant with the CPGs, with purchases from the multi-use list being more problematic. If this occurred it could have two unfortunate effects. Firstly it could lead agencies which were not particularly informed purchasers to become complacent that they had complied with the CPGs simply by purchasing from the central panel, when they should be exercising their own diligence in purchasing to ensure value for money. Secondly agencies taking easy refuge in the central panel would favour the firms on the panel which would be preponderantly large firms which will often, though not always, come with a price premium.

On the other hand it is possible (perhaps likely) that a central panel would also provide for a range of sub-panels. In this case the Blunn-Krieger model is similar to our own, proposed in the next chapter. The

main difference is that our own model is consciously crafted with the view that a rationalisation of panels should be used very consciously to improve the Commonwealth's capacity as an informed purchaser of legal services. If this is the case, the focus falls not just on the structure of the panels but also on the way in which the management of panels might help leverage more widely existing skills within those agencies which are currently the most informed purchasers.

VI. Lateral Economics' hybrid model: subject area panels with a multi-use list

> Whatever method is ultimately used, the interests of the Commonwealth would most efficiently be served if service providers for particular agency needs were identified and engaged using less reliance on elaborate process and more reliance on informed purchaser skills including knowledge of the market.
>
> Blunn-Krieger, 2009, p. 55, § 176.

Subject area panels

The model we suggest delivers many of the benefits of the multi-use list without some of the potential downsides. It is broadly speaking the obverse of the Blunn-Krieger hybrid model. As with the Blunn-Krieger model, there would be a multi-use list in the background with which any firm could register. In contrast to Blunn-Krieger, the panel arrangements would revolve around subject areas. There are a wide range of general areas of law which are in constant demand from many Commonwealth agencies. These include:

- employment law;
- general administrative law;
- privacy and information law;
- commercial and contract law; and
- general litigation.

As there is a substantial volume of general legal advice, one of the panels could be a generalist one. And there are some quite specialised areas in which there is substantial demand often relating to a quite narrow area such as freedom of information or privacy, though often firms that deal with one would deal with others. It should be a substantially less onerous task to set up panels in each of these areas as they are relatively constrained, with agencies' needs easier to define.

Other specialist panels should be established in areas of preponderant interest to one agency such as:

- general tax law;
- immigration law;
- social security law; and
- planning, infrastructure and property law.

Each of these panels would be managed by a single agency's legal practice. Agencies with a preponderant interest in an area would be its panel manager.[43] Where there was broader interest, the major user agency judged by OLSC to be the most informed purchaser would become panel manager.

Panel managers would establish and hold the tender leading to the establishment of the panel (in consultation with other likely panel users). They would be the custodian of performance information guiding purchasers in their search for best value for money and would provide services for a fee to buyers of legal services from the panel from outside their agency.

Where OLSC judged agencies capable of managing their own arrangements with panel members unaided,[44] the panel managers' fee to outside agencies would be a small contribution to the fixed costs of establishing and running the panel. For others, the panel manager would provide additional service, charged at cost, to help agencies become informed purchasers and optimise value for money. The precise arrangements under which this should occur should be developed by the General Counsel Coordination Group (GCCG) proposed in Recommendation 4.

Given that it would reduce the number of panels from around seventy to around a dozen or less, the mechanism would produce a large reduction in tendering costs. It could even be lower than the tendering costs of the central panel as the central panel would be likely to have sub-panels for specific subject areas. However it would not reduce tendering costs as much as the pure multi-use list option which would largely eliminate them. But the main purpose and benefit of the model is that it would move panels away from simple compliance with the CPGs towards hubs of expertise which could help deliver informed purchasing and train agencies to become informed purchasers themselves. The panel managers would also become custodians of the new information system that must be developed if the Commonwealth is to become a properly informed purchaser (see subsequent section).

Further, the arrangement of the panels into subject areas would ameliorate the tendencies in other arrangements to advantage larger

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[43] We have presumed here that the specialist agency is an informed purchaser of legal services. Clearly it should have the best available domain legal knowledge of the relevant area. If it is not currently an informed purchaser, arrangements will have to be made to ensure that it becomes one, and in the meantime, it should participate in any management of the relevant panel.

[44] This would require some finding by OLSC that they met informed buyer capability requirements.

firms over smaller ones thus giving agencies access to more competitively priced services where smaller firms were able to perform the work satisfactorily. It may also make sense to incorporate rules into the empanelment process to guard against the prospect that smaller firms will be discriminated against in the process of selecting the panel. This can occur indirectly where officers managing the panel are risk averse – as there may be a perception that better known legal services brands are a safer bet, and easier to defend if one is required to in some external audit. It can also occur because, as demonstrated above, the *ad valorem* cost of qualifying for panels (costs as a proportion of the value ultimately transacted) is much higher for smaller firms than it is for larger firms.

In establishing a general central panel (with a commercial sub-panel) and seven specialist sub-panels, Victoria stipulated that, except where made necessary by unsuitability of applicants, not more than two of the firms on the general panel could participate on any specialist panel and no general panel member could qualify for more than two specialist panels. Similar rules may be appropriate here, though it would be preferable if closer attention could be made to the specific problems at hand by ensuring that the costs of tendering are kept down and that any risk aversion not lead to any bias from officials in against smaller firms.

Table 2: Specialist panels in Victoria

The State of Victoria maintains seven specialist panels as itemised, with the budgets devoted to each for 2010-11 as follows.

Area	Budget ($m)
Property	$4.5
Intellectual Property & Technology Law	$3
Personal Injury	$2.1
Coronial Inquests	$1
Prosecutions	$0.87
Freedom of Information & Privacy	$0.73
Resources	$0.7

Source: Victorian Government

One matter that requires clarification is the relationship between the multi-use list and the panels. The current logic of panels suggests that all those purchasing within the subject matter covered by them should

be compelled to purchase from the panel. On the one hand the more purchasing can be aggregated into the panels, the more the Commonwealth can project its buying power. On the other hand co-ordinating multiple agencies' purchasing through a single panel can interfere with Departmental accountability and autonomy to achieve value for money.

We according propose the following compromise. Firstly we see merit in requiring those agencies which are not informed purchasers to purchase through the panel where they seek services covered by it if this is the course recommended by the panel manager through whom they are purchasing. But where agencies are informed purchasers there are competing considerations. On the one hand corralling them into panels should increase their own and other agencies' buying power. On the other hand exercising that buying power comes with the risk of a poorer 'fit' between the agency and its service providers.

Given the agency is an informed purchaser, we think any mechanism to encourage them to purchase from the panel should not involve direction from another agency. In our recommendation below we envisage that there should be some expectation that all agencies will seek value for money through the panel where possible. Further, it the panel process is generating better prices for agencies, this should be a natural outcome. However should agencies that are informed purchasers wish to negotiate their own arrangements outside the panel, on presentation of a written statement of their reasons to OLSC they should be free to do so.

Specific agency needs and a multi-use list

Although what we are proposing in the previous section would aggregate commonwealth legal demand around subject areas of the law for which there was substantial common demand from agencies, agencies will continue to have specialist needs – particularly relating to portfolio specific legislation and issues. Where the subject area panels do not provide satisfactory options, agencies could access appropriate firms through a multi-use list. The multi-use list would centralise basic administrative tasks required to qualify firms. In addition OLSC advise that they are able to pre-qualify the capabilities of firms' on the multi-use list. Doing this centrally would reduce a great deal of duplication that occurs in panel tendering.

As Mallesons commented in response to a draft of our proposal for subject area panels:

> It seems to us that good examples of where the Recommendation will work well are:

(a) areas of law specific to the agency given the responsibility of establishing the panel (for example, DEEWHR for employment law or the ATO for tax law)

(b) areas of law that are applicable to all agencies without much variation, for example constitutional law,[45] trade practices, property, IT and probity.

There are, however, some areas for which a centralised panel and a central informed purchaser would be less effective in achieving value for money and improving efficiency because while the area of law is fairly generic, either:

(c) the individual subject matter is highly agency-dependent and law firm capabilities in that area are better understood by the agency itself and their internal legal team and are not best understood by a central purchaser; or

(d) the area of expertise within that area is highly specialised, and is not commonly acquired by the Commonwealth.

We agree with these observations and believe that the multi-use list should be used to address the concerns raised. Once firms are on the multi-use list with their capabilities itemised, an agency should be able to identify which firms could assist with agency specific work. A relevant agency could then do business with those firms. Where a matter was a 'covered procurement' under the CPGs – generally where it costs more than $80,000 – agencies would often hold a tender for that job (as they do now within panels). But choosing from the multi-use list the agency could avoid the additional administrative load of an open tender. In making uncovered purchases below $80,000 by choosing from the multi-use list, the CPGs would require the agency to exercise appropriate diligence in obtaining value for money.

In appropriate circumstances – typically with larger matters – they might do by obtaining competitive quotes from selected providers on the multi-use list (as they would often do within a panel). But they should also be able to purchase services more informally by approaching single firms to do work whilst subjecting all such work to ongoing scrutiny to determine value for money. In this way firms would understand that the demand for those delivering the best value for money would swell at the cost of their peers.

A further issue is the successful projection of the agency's buying power. Here the agency could identify firms from the multi-use list with the

[45] However constitutional law is currently tied to AGS.

relevant capability and hold a simple 'price tender' in which firms bid the price they would be prepared to pay to receive some estimated amount of work or to be on an informal panel of preferred suppliers. To the extent that a tender for a panel is a 'purchasing event' under the CPGs which discharges the CPGs requirement for agencies to obtain value for money, this procedure would perform the same substantive function as the establishment of a panel. It would demonstrate value for money (capability plus a competitive price) and, particularly if the agency was an informed buyer, the price tender should also satisfy as a purchasing event, enabling the same kind of informal and immediate access to service providers as is provided by a panel.

Recommendation 1: Panels should be established in specific areas of law with substantial Commonwealth demand rather than agency-by-agency.[46]

Each panel should be established and managed by the legal practice of an agency judged by OLSC to the most informed purchaser with an interest in the area. The panel manager would be custodian of performance information guiding purchasers in their search for best value for money in the relevant legal area.

Subject to other recommendations, where agencies are not judged by OLSC to be informed purchasers, they would be obliged to purchase from these panels for appropriate legal matters. For a fee (to be set in consultation with OLSC to cover relevant costs) the panel manager would advise and mentor buyers of legal services from such agencies seeking to purchase from the panel.

Agencies judged by OLSC to be informed purchasers would be obliged to attempt to maximise their purchases of services within specific fields from the relevant panel in consultation with the panel manager. They could also seek to negotiate better rates than the general panel rate with panel firms.[47] However should informed purchasers wish to negotiate their own arrangements outside the panel, on presentation of their reasons to OLSC they should be free to do so.

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[46] One such area would be general legal services as required by most agencies. It would also make sense to start with discrete areas of law that apply in relatively uniform contexts across Commonwealth agencies as other initial candidates for subject-oriented panels. Agency requirements in terms of more complex, or highly specific areas of the law could be satisfied via the proposed multi-user list.

[47] It may also be appropriate to charge such informed users of the panel some low fee which represents the cost of establishing the panel. On the analysis in this report this figure should be below 1% per cent of the value transacted.

Those wishing to purchase legal services on matters outside the areas provided for in the panels could choose from pre-qualified providers on a multi-use list maintained by OLSC.

Ameliorate panels' role as a barrier to entry

> Given the complexity of the application documentation and level of detail which must be provided the preparation of a tender response is a time-intensive and significant task. For single jurisdiction, boutique and regional firms such as those operating in the majority in Queensland this equates to an expensive venture.
>
> Firms must make a commercial judgement about whether undertaking such a non-trivial exercise is viable for them when little relevant financial information is available with respect to the work required.
>
> *Queensland Law Society submission to Blunn-Krieger. (2009, p. 2.)*

We propose a further innovation. There is a clear tension between the extent to which the provision of legal services is an *experience* good and the extent to which tenders lock purchasers into assessments of the suitability of firms *in advance*. For if they are selling experience goods, a sensible way for a new entrant to enter the market is in a small way to limit buyers' risk until more experience is gained. In a market for experience goods, buyers will want to limit their risk with new suppliers until they gain sufficient experience with small, low risk purchases.[48]

Panels put a catch 22 in the pathway of such possibilities. It is difficult for a firm to get on a panel until agencies get experience with it. But it cannot get experience without getting onto a panel. In this way panels can operate as a barrier to entry and natural market development. Though the barrier is not absolute, it can impede the speed with which a new entrant can challenge incumbents and so impose competitive disciplines and introduce innovation.

Similar considerations can also make it harder for agencies to access smaller, more specialised firms. Large firms spread of skills is highly desirable and it is likely that agencies with substantial purchasing budgets will always want to purchase from some larger firms. However

[48] In another market for professional services Banerjee and Duflo, (2000) find that young firms, which have less reputational capital, are much more likely to be hired under a fixed–price contract than are older firms. This result suggests that firms use high-powered incentives for agents that have no reputation at stake, but are more willing to rely on more flexible lower- powered cost-plus contracts when the supplier comes to the relationship with more reputational capital. See also Lafontaine and Slade, 2008, p. 58.

when an agency commits to a limited number of suppliers on a panel to pursue close collaboration with each, it is riskier to do this with more specialised suppliers for one is left with less flexibility or competitive alternatives if a supplier performs poorly. Further, as the Queensland Law Society pointed out in its submission to Blunn-Krieger (see head quote above), the fixed costs of an application for a panel can be formidable for smaller firms.

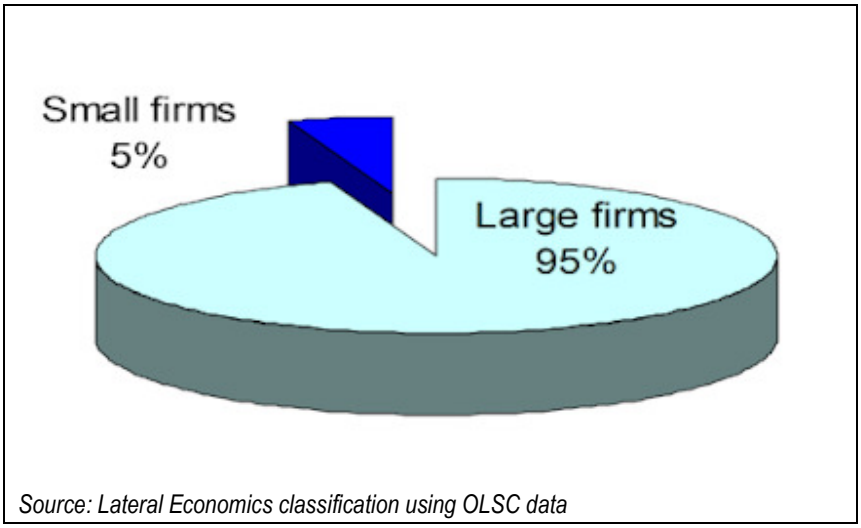
Agencies seek external provision with many different requirements. They may seek a firm with a broad spread of skills for a complex or geographically widespread matter, and/or they may wish to purchase advice that comes from, and can be demonstrated to others as coming from a very highly reputed 'brand'. Given the attractions of all these characteristics, firms price for them. Each accretion of value comes at a cost. Thus optimising value for money means that the Commonwealth should as far as practicable purchase only those services that it needs. Often, for instance, an agency will want a high level of expertise, but particularly if the work is for its own benefit, and not for publication, they may be indifferent to whether or not the work comes with the 'brand' of a top-tier firm.

In other areas of Commonwealth purchasing, positive actions are mandated to ensure that agencies take some effort to ensure that they are not discriminating against small or emerging firms, to foster the innovation and market development that smaller firms can bring and to address the way in which the red tape involved in government processes can discriminate against smaller, newer firms. The CPGs commit the Government to sourcing 10 per cent of its purchases from small to medium sized firms.[49] In this market however, our analysis of data held by OLSC indicates that legal services provision falls well short of this benchmark. It is also well below the result obtained across the Commonwealth where about 32 per cent by value and 56 per cent by volume of contracts go to smaller enterprises.[50] In many respects this is surprising given the lack of obvious scale economies in legal services.

[49] CPGs § 5.6 reads as follows: "The Government is committed to FMA agencies sourcing at least 10 per cent of their purchases by value from SMEs."

[50] Correspondence from the Department of Finance and Deregulation.

Chart 2: Proportion of small and large firms supplying legal services



Source: Lateral Economics classification using OLSC data

Further, although agencies necessarily contract with *firms*, to a substantial extent their reason for doing so is to work with *individual* lawyers and teams that they regard highly. Where these personnel move firms, the agency seeking their assistance should be able to move its business if doing so would better meet its needs.

Accordingly where panels are established, it is prudent, forward looking behaviour for new entrants to the market to be tested. This can be done by permitting some small portion of the expenditure on panel firms to be spent outside the panel, particularly on service providers which are judged capable of developing into new high value for money service providers – perhaps in specific niches – on future panels. It is also prudent for agencies not to purchase from panels where they become aware of opportunities in the market which match their evolving needs substantially better than panel members can.

Virtually all the pricing and relationship benefits agencies can secure from committing all their purchasing to panel members can be secured by committing the vast bulk (e.g. 90%) of purchases to panel members. Accordingly the intention to facilitate a small amount of out of panel purchasing should be made clear when panels are established. The proportion available to off panel firms in this way should grow over the period of the panel, from (say) 5 to 15 percent.

Out of panel purchasing would not be mandated, but rather, encouraged up to the specified level for panel managers that sought to do it. It would also be worth resourcing this activity modestly if it were judged that it could bring greater competitiveness and innovation and lower costs to the market in the future. It will also be necessary to put in place some process for cost effectively identifying and selecting promising service

providers in an effort to foster competitive dynamics, innovation and market development. The panel manager should have responsibility for doing so unless some other agency(ies) agree(s) to do so.

Recommendation 2: Where panels are established, some small portion of the expenditure on panel firms, say 5 per cent (growing to 15 per cent over the course of the panel's existence), should be available to be spent outside the panel, particularly on smaller service providers offering better value for money.

Out-of-panel purchasing should not be mandated, but would be encouraged up to the specified percentage level. The panel manager should provide some means for assisting agencies to chose out of panel providers cost effectively.

Implementing this recommendation would also make it easier for agencies to engage those regional and smaller firms that had not qualified for panels on an *ad hoc* basis where it made sense without undermining the integrity or the advantages of panel arrangements.

Ongoing promotion and relegation to a group of pre-qualified providers

The private sector has a broad spread of arrangements for engaging external providers, from panel arrangements to pure relationship models in which providers are given favoured access to lower costs by close collaboration with flexibility retained to promote outside firms to be amongst the favoured few and to relegate to outside status firms performing less well.[51] But panels with their cumbersome establishment procedures predominate in the public sector, essentially because agencies feel comfortable that they have a form which enables them to comply with requirements that they demonstrate open competition and value for money.

As information systems improve over time as envisaged in this report it should be possible for the role of panels to evolve into something more flexible, and less costly to establish and maintain. These would be groups of firms that are well known for providing high value for money service and who, on account of that, and on account of favourable terms negotiated with them, would be heavily patronised by agencies.

But there would be no regular 'all or nothing' review of this group. Instead the group of preferred providers would be maintained as most markets are, by continual competitive pressure and ongoing negotiation. This should be possible where it can be demonstrated that information systems and panel managers can evaluate service providers'

[51] See eg Beaton Consulting, 2006, p. 32.

performance on an ongoing basis and where they ensure that there are always pressures both within the group and from outside.

Where discounts can be obtained within a panel, it should be able to negotiate them outside a panel, by holding out rewards in the form of greater volume or more stable demand. And at the same time, the group of firms that is known to provide good value-for-money would always be kept open for newcomers who could prove themselves and challenge incumbents.

Enhance the future value of good reputation and simplify tendering where possible.

Reputation (often captured in a recognised brand) is the central means by which consumers protect themselves in circumstances where they have imperfect information about the goods they are buying. A system which measures the quality of service providers' performance and which circulates that information would enable purchasers to leverage each others' experience and evolving knowledge. This does not only ensure the 'static' benefit that agencies are better placed to make the right choices in service providers.

It sets off dynamics that are extremely healthy in a market in which buyers are often at a disadvantage because they cannot fully determine the quality of what they have purchased until they have purchased it, and sometimes not even then. The more service providers are focused on impressing their existing clients to win future work from them, the more this enhances their tendency to virtuous behaviour. Reputation leverages this effect because it extends the future rewards (or penalties) of impressing (or disappointing) one client to the prospects of working for other clients in the future. Agencies can further intensify those incentives by rewarding the best performers not just with more work, but with less onerous requirements for obtaining further business.

Recommendation 3: Where agencies are judged by the Attorney General's Department (advised by OLSC in its role as secretariat to the GCCG – see below) to be informed purchasers, those agencies should be permitted to offer their best service providers streamlined means for qualifying for further work, including future panel membership.

Most particularly, where a panel is being rolled over with a tender being held to establish the new panel, the agency should be able to invite the best performing service provider(s) on the past panel, as judged by ongoing service quality assessments, to participate in a streamlined (and therefore less costly) tender process for the new panel focusing mainly on ensuring that its price remains competitive. To achieve better value for money in purchasing of legal services, we must candidly

acknowledge their status as experience goods and dispose of the fiction that *ex ante* assessments of future performance are more reliable than actual performance as experienced by the informed purchasers of the Commonwealth.

Benefits from reform

Lateral Economics was requested to quantify the benefits of these proposals. Even though some of these gains can only be quantified in the most broad and indicative manner, keeping a 'best guess' of potential gains from different sources has been a worthwhile discipline in determining where we focused our own energies. In fact all the reforms we have proposed are interrelated. But isolating them for the purposes of itemising the relevant cost reductions to which we think our recommendations could lead, we divide them into three categories as per the following table.

Table 3: The prospective gains from change

Change	*Quality gains*	*Risks*	*Potential Gain (%)*	*Potential Gain ($/pa)*
Reducing tendering costs	Possible if appropriate model	Low but non-negligible	2 – 2¾	5 to 7.5 million
Exploiting market power	Negative	Moderate	2½ - 4	6.5 - 10 million
Better informed purchasing and external talent management	Positive [52]	None	7 – 15	18 - 38 million
Total			**11½ – 21¾**	**29 – 56 million**

Establishment of panels is a fixed cost currently accounting for around 3.85 per cent of the total cost of legal services purchased through panels. It is true that the fixed costs of establishing larger panels are likely to be somewhat larger than the cost of establishing smaller ones, but this is essentially because, with a larger base over which to amortise the costs, and with panels built to facilitate more than one agency's needs, somewhat more is likely to be spent, in establishment. For

[52] See Dore, 1983, p. 475.

instance one agency estimated the cost of a central panel to be around twice the cost of an agency specific panel.

It is also likely that more firms would tender, and that they would put more effort into tendering for panels through which more business was done. Accordingly for the sake of illustration if the number of panels were reduced from 72 to ten and the total establishment cost for each panel was twice what it would be for an agency specific panel, the costs of the new arrangement are 28 per cent of the old one. Accordingly we suggest that reducing tthe number panels from around 72 to around 10 should see establishment costs fall by 50 to 75 per cent which would save around $5 to $7.5 million annually.

Likewise this rationalisation of panels should enable panel managers to secure better deals from firms seeking to qualify for panels. It was not possible to obtain data on the extent to which panel size correlated with discounts offered by firms. Our soundings in industry and reading of the literature suggest that discounts of the order of 20 per cent are available to large buyers. Assuming that most of are already captured by the larger panels suggests gains of between 2½ and 4 per cent or around $6.5 to $10 million.

The recommendations in this report should lead to better informed purchasing which can expected to produce gains of the following kind.

- All agencies will be better informed about *other* agencies' experiences with external providers, leading to more rapid and sure-footed responses to quality and price signals from providers.
- Agencies will be able to pinpoint how much work particular partners in firms and their teams are doing for them (and others), enabling better external talent cultivation and management.
- More focus on a disciplined environment for systematic prediction and ongoing measurement of the accuracy of predictions – of such things as the cost of matters and their likely outcome – should lead to improvements in the efficiency of work allocation and the more rapid identification of and learning from emerging best practices.
- Better market development, including purchasing from smaller firms with knock-on benefits in terms of price discipline in the case of larger firms.
- Reduced duplication where multiple agencies seek advice on the same matter of law either without realising the duplication or

realising it, being unable or unprepared to share other agencies' work.

- Better management of routine legal matters by agencies that are not currently informed purchasers.[53]

Given all these potential benefits we believe the cumulative benefits available from the advantages of informed purchasing could be conservatively estimated at between 7 to 15 per cent.

[53] The ANAO reported in 2005 that "a large percentage of agencies were not satisfactorily monitoring performance of providers and dealing with deficiencies as those arose suggesting a large majority are not informed purchasers. We conducted a very informal 'straw poll' of agencies and firms asking what proportion of Commonwealth spending on external legal services was by informed purchasers. The responses ranged from 25 to 80 per cent. If becoming an informed purchaser could reduce costs by 15 per cent the range of benefits implied by these responses is between 3 and 11.25 per cent.

VII. Measuring performance: becoming informed

Any management system must seek to measure as best it can the cost and quality of the work it manages. The ease with which this can be done will be a function of circumstances. However as the ANAO reports, agencies commonly measure the quality of work they purchase from outside.

Box 6: Rating Legal Services

For feedback to legal services providers, agencies commonly have their in-house client rate legal advice received, for example on a scale of 1 to 5, with comments as appropriate, on the following questions

- Was the lawyer pro-active in providing the services?
- Did the lawyer keep the client informed of progress?
- Was the lawyer readily contactable?
- Was the advice provided on time?
- Was it good advice: ie good quality, correct, useful and practical?
- Did the service meet expectations?
- Did the lawyer confirm that there was no conflict of interest?
- Did the service give value for money (having regard to what it would have cost had the advice been provided in-house, and taking account of in-house expertise)?
- Was the outcome cost within agreed budget?
- Would you use this lawyer/firm again?

Australian National Audit Office, 2006, p. 45

A simple inspection of the kinds of measures used indicates different degrees of subjectivity in these measures. Nevertheless it is obviously commonsense for such performance measures to be collected systematically. Further, the more frequently similar cases occur the richer the data they generate and the stronger the possibility that strong signals about service quality can be extracted from the data. This fact alone suggests that standardising such quality measures would generate gains.

Commoditised legal services

Some managers of legal services contracting in the Commonwealth distinguish between 'commoditised' legal services and those services which cannot be so characterised. Where the salient characteristics of

much legal services provision has have a high degree of uniqueness (as for instance is often the case for a single large transaction such as the privatisation of some government business), a commoditised service can be well specified and understood in advance as similar to some well known, relatively standardised process.

The classic example is high-volume litigation. Thus for instance the Australian Customs and Border Protection Service proceeds against alleged offenders spending a substantial portion its nearly $9 million total expenditure on fairly routine litigation. The volume and regularity of this work enables the Department and its service providers to get a good understanding of the value for money they receive for outsourcing the legal services used in this litigation.

In its 2005 performance audit the ANAO provided us with a snapshot of the extent to which legal work was attributable to different categories of work. As it reported (2005, pp. 42-3 § 2.35-4)

> Litigation accounts for 58 per cent ($207.6 million) of categorised legal expenditure, and is clearly the major category of legal expenditure. The ANAO notes that most of the top ten agencies have a significant litigation workload, and that litigation, legal advice on specific agency legislation and commercial/contract law together accounted for over 90 per cent of categorised legal expenditure.

Table 4: Legal Expenditure in 2003-2004 by category of legal work

Legal Category	Internal ($m)	External ($m)	Total ($m)
Litigation	103.1	104.5	207.6
Legal advice on specific agency legislation	46.7	40.4	87.1
Legal advice to support corporate functions	8.1	5.9	14.0
Other legal advice	8.3	4.0	12.3
Commercial or contract law	12.3	18.8	31.1
Management/corporate tasks	5.8	0.5	6.3
Sub total	**184.3**	**174.1**	**358.4**
Unallocated	45.5	42.1	87.6
Total	**229.8**	**216.2**	**446.0**
Note: Two agencies were unable to calculate or estimate their legal expenditure by these categories, resulting in unallocated legal expenditure of $86.8 million.			
Source: ANAO based on audit survey data (from ANAO, 2005, p. 42). Later data was unavailable.			

A good deal of the litigation and at least some of the other work would be relatively routine and in that sense commoditised or comoditisable.[54] In such an environment, service providers may be prepared to take on some of the risk of each case with pricing arrangements which share some of that risk with the purchaser. Thus for instance a service provider may agree to charge a fixed price for each matter, thus capturing any savings it can make in per matter fees, at the same time as taking the risk that costs may blow out on some cases.

And a good understanding can build up between the purchaser and its providers as their respective performance against easily measurable

[54] The proportion of work that is comoditisable may be overestimated by these ratios as the most comoditisable work will often be the litigation of smaller cases, with larger cases requiring an individual approach.

parameters like legal costs, outcomes and speed of resolution in each case can be measured and compared with one another. Here competition between firms, and communication between them and their client will not just discipline prices but will drive learning within the whole system. If a particular firm consistently achieves better results than another in any or all of these dimensions, or for instance does so in particular kinds of cases, their better practice can be investigated to learn from it and/or their superiority can be rewarded with greater work and/or the greater profits that might come with innovative charging models.

Comoditisable work should also present opportunities for effective 'piggy backing' of one agency's experience with another smaller agency's need for assistance in purchasing legal services.

Information sharing

> Q 5 (e) To what extent is your own method of assessing firms' performance similar to other agencies (please select one digit from 1-7 next to each characteristic)
>
> (i) approaches: Not at all 1…2…3…4…5…6…7 A great deal.
>
> (ii) systems: Not at all 1…2…3…4…5…6…7 A great deal.
>
> (iii) definitions Not at all 1…2…3…4…5…6…7 A great deal.
>
> If there is substantial similarity, please elaborate on which agencies have aspects in common with you.
>
> Response: N/A as we have not compared with other agencies.
>
> *Agency response to Lateral Economics survey, 2011*

By generating and sharing comparable data, agencies could learn from one another both how to manage outsourced legal services better and also which service providers provided best value for money at different kinds of matters. With reputations now more transparent across the Commonwealth, there would be stronger incentives on providers to deliver good value for money because there would be more to gain than the business of just one agency, or group thereof, and of course more to lose from not performing as well.

At present as far as information sharing goes, one would be hard pressed to claim that Commonwealth agencies can crawl, much less walk. The response to one of our survey questions on the matter recorded at the head of this sub-section was broadly representative.

The General Counsel with whom we met were mostly well known to each other, and there has been some activity in the last year to establish a General Counsel group to discuss common issues and to share information. This is in its vestigial stages and has had only a few meetings. Progress has been slow. In the meantime, each agency has its own system for managing the flow of external legal work, each with its own definitions and KPIs.

That this should be put right is, fortunately, both the least contentious and most important suggestion of this report. It is also possible to state with great confidence *how* it should be put right, though, because it requires a specific people and agencies to co-operate and to compromise in order to meet common objectives, it must rely on their good will.

It would be possible to conclude from what has been said that some common system for capturing information from agencies as they manage their purchasing of legal services should be imposed on agencies. Yet if this were done, not only would it meet stiff resistance, but it would also quite likely be the wrong system. In other areas (for instance statistical collections), rather than re-engineering agencies' systems those agencies have been brought to agree 'minimum datasets' compiled from existing systems according to agreed definitions and common standards which can then be shared among interested parties. This can then serve as a platform for growing co-operation over time.

Adopting common definitions and standards to facilitate information sharing

It is a commonplace in government that while it is highly desirable that certain information be shared among key personnel carrying out similar functions, doing so can be difficult between different agencies because their respective information systems militate against it.

The challenge is to share agreed information whilst minimising the disruption to existing IT systems - which cannot be significantly reengineered to meet the new requirements because of the potentially very large amount of investment that has already been sunk into getting them to their current operational state. This challenge is often met by the adoption of common definitions and standards and agreeing that each agency will contribute a 'minimum dataset' in the interests of the common good as a by-product of its existing operational systems.

Common definitions and standards need to be universally adopted among those wishing to share information to prevent spurious comparisons. In the present application common definitions would need to be adopted by each agency wishing to share information of key

aspects of the legal services it obtains (either from in-house or external sources).

An example would be a shared definition of what constitutes a legal 'matter' (e.g. so that they can be consistently counted and compared across participating agencies). Such agreed definitions are then usually accumulated in the form of a 'data dictionary' (in this case a collection of legal terms whose definitions are agreed among all agencies wanting to share information of various aspects of legal services). An example of a standard would be a shared understanding about how to cost an individual legal matter (including what components of cost are to be included). There has already some progress on this matter under the auspices of OLSC's information gathering and reporting responsibilities, although a look at the relevant report released in December last year illustrates the difficulties being faced by OLSC in this regard.

A minimum dataset (as its name suggests) would include the minimum information about legal services relevant agencies agree to share. Examples might include the number and cost of legal matters an agency handled in a specified period, what types of advice was sought on what matters and with what results, agencies' experiences with individual outside legal services providers, etc.

Representatives from each participating agency would then undertake to arrange for their various operational systems to produce the minimum dataset on a regular basis, and to share it with other interested parties. The resulting aggregated dataset – now populated with each participating agency's dataset(s) – would then be made available to be queried/analysed by accredited parties (e.g. via a 'gateway').

Over time, the minimum dataset is expanded to include further key variables/performance measures, etc. This approach to sharing information means that rather than start with a grand scheme with which all systems must become compliant, that scheme is built from the bottom up, rather than the top down, minimising costs and the risk of the project failing either because there is something flawed in its initial conception or because of some technical failure. According to this model, the information-sharing initiative starts modestly and then gathers pace as the parties gain experience in working towards common informational goals. At least at the outset the initiative does not require major re-jigging of agencies existing standard operating procedures.

The need for leadership

The problems of co-ordination have been known for some time, and as its name suggests, the Office of Legal Services Coordination (OLSC) has been intended to deliver co-ordination in the face of the dramatic expansion of agency autonomy in the wake of the Logan report. This is

not an uncommon situation in the Commonwealth where agencies are accountable both for achieving ministerial and agency specific objectives whilst doing so consistently with some agency or government wide policy. There are parallels between this area and the Commonwealth's purchasing of information and communication technology (ICT).[55] In his Review of the Government's ICT use in 2008 Sir Peter Gershon concluded that previous emphasis on the autonomy of individual agencies had left important deficits in the whole-of-government coherence of ICT management and agency purchasing capability. Similar findings were made by Blunn-Krieger and our own study.

Yet there remains the need for action in legal services purchasing. Recommendations to improve information sharing have been being made since at least the Tongue Report of 2003. Accordingly it is imperative that agencies regard the need to share information as a first order imperative. One aspect of our own approach is to try to bolster the formal responsibilities for coordination invested in OLSC with the networked leadership and collegiality that can come from co-opting the most respected General Counsels into a leadership group to drive reform forward.

Recommendation 4: A General Counsels' Coordination Group (GCCG) should be convened comprising 6 to 8 highly regarded General Counsels from agencies with a representative mix of legal practices.[56] With the OLSC resourced to act as its secretariat, the GCCG should:

A. Agree a plan to harmonise the information standards by which all agencies manage their legal purchasing and assess the value for money they are achieving to enable data to be comparable so that it can be shared.[57]

The aim should be to introduce a Commonwealth-wide means of electronically recording performance appraisals of and interacting with service providers with common definitions and standards to ensure that relevant agency information is captured and easily shared across agencies.

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[55] Note for instance Ian Reinecke quoting a Departmental CIO commenting "AGIMO acts with one hand tied behind its back - it is too dependent on agency goodwill". Similar views have been expressed to us regarding OLSC.

[56] Membership from one or two highly regarded buyers of legal services from large private corporates could also be useful.

[57] It may be appropriate to decide basic standards relatively quickly, with a second round of more thorough standards agreed experience with the information generated initially.

B. **Assess the capability of all Commonwealth agencies making substantial legal purchases to be informed purchasers.**[58]

C. **Produce and implement a plan to raise those capabilities to an acceptable standard.**

D. **Produce a plan to build collegiality and skill sharing between agency practices to lift service wide capability in an ongoing way.**

To avoid delays in progress, clear timetables and public benchmarks of success will be necessary alongside an alternative plan to impose more centralised solutions if the GCCG fails. As occurred with the Reinecke Review of the Gershon reforms, there should be a review of progress after an appropriate period.

One of the disadvantages of agency autonomy has been the difficulty of establishing strong networking between government lawyers in different agencies. In light of this it may be appropriate to aim for a Commonwealth wide legal service similar to the UK Government Legal Service. Ideally this would be after initial steps proposed here had been taken. However if the 'first best' process of cooperative consolidation proposed falters, a Commonwealth wide legal service could provide the means by which scarce informed purchasing skills might be able to be more effectively shared throughout Commonwealth agencies to enable the Commonwealth to become a more fully informed purchaser of legal services.

[58] 'Substantial' legal services purchases should be those over some threshold decided by the GCCG.

VIII. Enhancing future performance by tracking experience: Gruen Tenders

Firms are hired and qualify for panels based on expectations about their future performance. This chapter outlines a mechanism for refining expectations by seeking predictions of future performance by those who are likely to know best of all – the service providers themselves – and then adjusting those predictions according to accumulated experience of the accuracy or otherwise of the service provider's past predictions.

If one asks a service provider how they believe they will perform, one expects them to provide answers which are biased or unbiased according to their temperament, their knowledge and experience of providing such estimates and also the incentives they face in offering such prognoses. First proposed in 2002,[59] Gruen Tenders provide a procedure by which, just as auctions elicit from buyers a revelation of their willingness to pay, service providers can be trained and induced to provide their best unbiased prognosis of likely future performance.

This elicits information over and above the information that purchasers can collect about past performance discussed so far. And that information can then be used to identify the service providers most likely to do the best job. The Gruen Tender can be used in virtually all circumstances where quantitative (including probabilistic) prognoses can be made, but its workings are explained below with reference to legal services, and in particular the handling of a particular case for litigation.

It is important to note that, the process can be used to determine purchasing decisions, or simply as a device to greatly increase the richness of the information base on which judgments will be made to allocate work. Whether or not the process is used to allocate work, it can make a substantial contribution to enriching the information base upon which service providers' reputations are built. Further, though it works well with 'commoditised' legal services it also has strong attractions where services are not commoditised, but rather are customised.

The process involves building a system which takes participants through three steps:

Step One: The service provider is required to offer prognoses in terms of a particular quantitative outcome – for instance the ultimate price that will be paid for an advice – or the chances of success in a particular case.

[59] Gruen, 2002, p. 92.

Step Two: Service providers' prognoses are logged and then compared with their corresponding results as they become known. The system can then measure both the accuracy and any bias in past prognoses. Thus for instance, if the service provider has on average been 10 percent more optimistic than their results would justify this fact would be recorded in the system.[60]

Step Three: Once the system has sufficient data to give the measured past bias or 'optimism factor' some statistical robustness, 'raw prognoses' provided in Step One' can be 'moderated' to generate unbiased prognoses from each service provider which 'washes out' the biases they've demonstrated in the past producing unbiased prognoses.

To take the example above, if a legal provider's optimism factor was 12 percent, and its raw prognosis for providing advice was $20,000, their moderated prognosis would be $22,400 ($20,000 plus 12% of $20,000). It would be clear that an agent with a higher raw prognosis of $21,000 but an optimism factor of -5 percent would achieve a more favourable moderated prognosis indicating that the provider tended to come in somewhat under their predicted costs. This is illustrated in Table 5 below where the provider chosen as the most likely to minimise cost is Provider B.

Table 5: A Gruen Tender applied to pricing a brief

	Raw Prognosis	Correction for past bias	Expected result
Provider A	$ 20,000	12%	$ 22,400
Provider B	$ 21,000	5%	$ 22,050
Provider C	$ 21,000	-5%	**$ 19,950**

Gruen Tenders and litigation

One might also be interested in the service provider's estimate of the likelihood of their winning a case. Here a legal service provider would be required to estimate their chances of concluding a case successfully according to some agreed definition of success which would presumably include a favourable judgment or some minimum/acceptable financial outcome in a settlement. In the example set out in the table below, the service provider which offered the least optimistic raw prognosis is nevertheless indicated as the most propitious service provider once prognoses are moderated.

[60] Particularly where prognoses are expressed as probabilities it will often be more appropriate to use some measure of optimism other than a percentage of prognoses. We abstract from this consideration in the current discussion.

Table 6: A Gruen Tender applied to choosing a litigation lawyer

	Raw Prognosis	Correction for past bias	Expected chance of success
Provider A	85.0%	13%	**96%**
Provider B	91.0%	0%	91%
Provider C	95.0%	-5%	90%

The service providers might provide prognoses as follows with the indicated service provider being that with the best moderated prognosis. One powerful benefit of the Gruen Tender can now be demonstrated. Just as crude performance ratings in health care can generate incentives for the patients in greatest need of care to be turned away (because they have the highest risk of mortality or complications which would damage the hospital's reputation for safety) the same kind of problem can bedevil performance ratings of legal services providers. Thus the ANAO Better Practice guide (2006, p. 45) observes

> Similar ratings could be applied to a law firm that litigates on behalf of the agency. However, the firm's success rate in winning an agency's cases in court may not be an appropriate measure of performance if the cases were difficult.

Yet this problem is generated by the fact that, with litigators as with health care providers, a single case is typically only ever dealt with by one service provider. When no two cases are the same it becomes problematic working out whether the better results of one service provider are a result of performing better or of receiving easier cases. With the Gruen Tender however, each service provider approached generates a prognosis for a case, which prognosis is then converted by the system into the expected chances of success for that service provider on that case. This expectation can then be easily compared between service providers who have provided a prognosis.

Where the system generates stable expected outcomes for one service provider over a range of cases, one can be very confident that one is observing superior performance and not luck in the allocation of jobs. Different service providers may emerge as the best performers on different kinds of cases, in which case they can be chosen for cases according to that information, but if this is not the case, the Gruen Tender system will reveal the likely best (and worst) performers. Of course the quality of service is only one aspect of service delivery and other issues such as price are also relevant to securing overall value for money.

Commenting on the related but slightly different procedure of purchasing via e-auctions, Rothkopf and Whinston (2007, p. 406) comment on the possibility that e-auctions can damage relationships with long term suppliers. This should be avoided at least to the extent that this does not compromise the Commonwealth's driving further improvements in value for money purchasing. The architecture outlined here is highly flexible, and so can be introduced in a carefully exploratory, rather than a peremptory way as service providers and their clients get used to it and come to appreciate its strengths and weaknesses.

Information generated using the arrangements need not be used for allocating jobs which is to say that one can borrow from the architecture of the Gruen Tender without using it to tender work. Indeed, given its novelty, it may be preferable that they be used initially simply to enrich the information base of agencies, though over time one of the most valuable uses of the information will be in selecting the best value for money service provider. Even here however, this need not be done in a way that is either mechanical or exclusive.

Generally agencies will use their judgement in allocating work but that judgement will be conditioned by the information available to them. The procedures outlined here will add to the available information, help correct some biases, and exert pressure for service providers to discipline their own thinking and representations to agencies on how well they are likely to perform. Further, the system may allow more finely grained choice about how particular jobs are allocated. The prognoses particular firms give themselves may provide information about their specific strengths and weaknesses in different kinds of jobs. In this way, the system might considerably streamline the process of tendering. The benefits would accrue as lower tendering costs for purchasers and providers alike. Alternatively more streamlined processes and more finely grained performance information might enable the allocation of jobs which more satisfactorily matched job requirements with particular skills of service providers.

For instance, it may be possible for simple one page summaries of impending litigation to be posted on a web-site for panel members to indicate their respective interest in taking particular jobs. Panel members could indicate their interest and their expectations of the results by offering their prognoses of individual cases, with their recent average performances in the various metrics being their default prognosis which could be overridden by service providers to reflect any expectation they had of their being able to perform at some standard other than the defaults set in the system. Of course their respective suitability for the job would be determined not by reference to their raw prognoses, but by

reference to their prognoses as moderated to reflect the system's experience with any bias in their past prognoses.

Contracting the supply of multiple attribute services

Where an auction or tender is decided on in a purely objective way, which is to say a mechanical way – as is the case with a house auction – it is necessary for the architecture of the bidding to converge to a value which determines its ordinal rank amongst other bids. This is problematic where as in this case, the decision as to who will be the successful bidder depends on multiple attributes of service. Value for money is determined not just by price, but by quality which is itself a multi-dimensional concept embracing such things as thoroughness, relevance, accuracy, business relevance, timeliness, responsiveness, the client's confidence that he has not been under or over-serviced and so on.

While various means have been developed to hold 'multi-attribute auctions' [61] the problem is not merely the difficult technical problem of the architecture of the auction, but the more fundamental one which is that major aspects of job quality can never be perfectly reflected in the metrics into which bids in the auction would need to be converted. As a result, we expect that judgement will remain, necessarily, a major part of the process of choosing the best value for money provider.

In such circumstances IBM has crafted a method of auctioning its purchasing of legal service provision. The auction is over multiple attributes, but is mediated by a process of further negotiation between IBM and the winner of the auction. This not only serves to give IBM the chance to negotiate further improvements from the bid of the winner but also enables finer judgements than are possible on the auctioning system.[62]

The Gruen Tender process can be valuable here also, as it can be used to develop prognostic foresight in any dimension. Thus for instance, where a department has a system tracking the kinds of quality metrics outlined in Box 6, the default presumption will generally be that a service provider's future performance in any of the areas measured by these metrics will be the same as its past performance over some relevant period. This could remain the default presumption. Nevertheless if a service provider had put in place some system to improve its performance in some way, it would be able to indicate its own expectation of performing better than its historical record would show

[61] Bichler and Kalagnanam 2005

[62] Tunca *et al*, 2010.

thus flagging potential changes in performance in advance of their delivery.

Likewise if the relevant information is input, the system will be able to provide information at finer levels of detail. Given the importance of determining the quality of particular people working on projects it would be possible to encode this information into the system and so generate prognostic information on the impact of such personnel on the various service quality metrics collected. One might also seek to use it to generate data on matters that are of great importance to the Commonwealth obtaining value for money such as the client's perception that they have received the appropriate level of service, not having received too little or too junior attention to some matter and not having been charged for more hours of work than was appropriate to deal with a matter.

Again the more such measures can be shared across agencies, the more valuable the system becomes not just for its 'first round' effect of enabling an agency to find a better deal, but also for the way in which it intensifies the incentives for service providers to perform at their best. Where the client depends so crucially on being able to trust the service provider's judgement and integrity, a Commonwealth wide reputation for having the confidence of ones clients not to be over or under-servicing would be a highly valuable prize to win and keep. All this goes to reinforce Picci's comment (2010, p. 6) quoted earlier, that "[t]he more important reputational considerations are, the more likely it is that the balance will tilt in favour of virtuous behaviour".

360 degree vision.

As the system develops it can be further refined. For instance in generating metrics in some of the more subjective areas of determining service quality, some appraisals will be more generous than others. By a process analogous to the calculation of the optimism factor of service providers, one can with sufficient use of the system determine which users are more and less generous and allow some correction for that.

IX. Conclusion

This report advocates significant changes to the way the Commonwealth purchases legal services through Australian Government agencies. Conceived of as a package of inter-related measures, key elements include:

- A focus on ensuring that Commonwealth agencies are informed purchasers of legal services.
- The systematic collection and sharing of information concerning the extent to which external providers are providing value for money
- A move away from agencies running their own legal panels in favour of what might be called nodal or 'cluster' panels focusing on particular areas of law, supplemented by a multi-use list to cover other areas of the law on which agencies may need external advice.
- Earmarking of a small proportion of panel work to be done by non-panel firms in order to encourage development of the external market for legal service provision to the Commonwealth favouring small to medium-sized (and regionally based) law firms. This proportion would grow over the course of a panel's life so that the panel manager was in a position when selecting the next panel of having gained experience with the most promising firms outside the panel.
- Lowered tendering costs for both purchasers and providers of legal services to the Commonwealth taking the form of streamlined empanelment arrangements extended to firms with a demonstrated track record of providing value for money to the Commonwealth in its ongoing purchasers of external legal services.

Implementing these changes will be challenging and (inevitably) time consuming – calling for an implementation plan with milestones and timelines to be adhered to if real progress is to be made. Observations have been made for nearly a decade on the importance of better coordination and information sharing and the importance of ensuring more Commonwealth agencies are informed purchasers. The risk is that without leadership, firm resolve from the highest levels within Government, and further, the setting of clear benchmarks, progress will continue to stall – with another review commissioned in due course.

X. Terms of Reference

Lateral Economics is asked to consider three specific proposals in this context: firstly - the establishment of a multi-use list, which would pre-qualify law firms for providing services to the Commonwealth, secondly – a central panel, and thirdly – maintaining the status quo of agencies being responsible for their own procurement of legal services through the operation of Appendix F of the *Legal Services Directions 2005*.

The examination should provide advice on the advisability of pursuing the proposed options for improving the way in which the Commonwealth purchases legal services, indicate whether efficiencies or quality improvements are likely to result from the implementation of the options (or alternatives identified by Lateral Economics) and what the approximate quantum of those efficiencies or quality improvements may be, as well as alternative models, ideas or options for improving legal services procurement which Lateral Economics may wish to put forward. It is understood that any quantification offered is likely to be indicative, rather than based on rich econometric studies or a fully specified model of the relevant market.

The examination will be presented in a report to the Attorney-General's Department. The structure of the report will cover the following five aspects:

1. The current situation
2. Problems with the current situation
3. The proposed arrangements and how they address the problems
4. Problems that the proposed arrangements do not address
5. Options available for solving those problems.

Completion of the examination and preparation of the report will be achieved in six steps:

1. A literature review on the economics of purchasing expert services – with particular attention paid to the purchasing of legal services
2. One round of initial interviews would be held with stakeholders – both departmental purchasers of legal services and the providers of those services.
3. The provision of a draft report to the Department.
4. A second round of consultations with stakeholders to further explore issues and options identified by Lateral Economics.
5. An opportunity for the Department to provide feedback.
6. A final report providing advice on the current situation, problems with the current situation, the new arrangements and how they address those problems, problems the new arrangements may not solve and options available for solving those problems.

XI. Glossary

ANAO	Australian National Audit Office
CPGs	Commonwealth Purchasing Guidlines
FAHCSIA	Department of Families, Housing, Community Services and Indigenous Affairs
GCCG	General Counsel's Coordination Group
ICT	Information and communication technology
KPIs	Key performance indicators
LSDs	Legal Services Directions
OLSC	Office of Legal Services Coordination

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Appendix A: The demand for and supply of legal services to the Commonwealth

A1 Introduction

This appendix assembles available estimates of the demand for and supply of legal services to the Commonwealth (in practice, Australian Government agencies of various kinds).

Following Blunn and Krieger (2009:15),[63] 'legal services' are taken to mean:

> … those professional services used by agencies to determine their legal position on issues, to manage legal processes, to advise on managing legal risk or achieving results lawfully, or to document contractual or other legal obligations.

In compiling statistics on legal services (e.g. in its *Legal Services, Australia* series of publications), the Australian Bureau of Statistics (ABS) defines legal services as comprising:[64]

> … legal representation and advice, the preparation of legal documents and title-searching services (i.e. establishing the legal ownership of a property).

To supplement available quantitative legal services information from a variety of sources (e.g. ABS, Blunn and Krieger 2009, the Legal Services Expenditure Report 2009-10[65], the ACLA/CLANZ Legal Department Benchmarking Report 2010[66]), this appendix also summarises responses to the Lateral Economics survey of selected legal organisations conducted in January 2011.

A2 Demand

Like many other goods and services, legal services embody various characteristics (apart from their price), which consumers take into

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63 Blunn, AS and Krieger, S (2009), 'Report of the Review of Commonwealth Legal Services Procurement,' Commonwealth of Australia.

64 ABS (2009), *Legal Services, Australia, 2007-08* (Cat. no. 8667.0), explanatory notes.

65 Commonwealth of Australia (2010), *Legal Services Expenditure Report 2009-10*, Office of Legal Services Coordination.

66 Catalyst/Team Factors Ltd (2010), *Legal Department Benchmarking Report 2010*.

account when they procure such services. Thus in judging whether to engage a particular law firm on a matter, the prospective purchaser will likely take into account attributes such as the firm's track record in handling similar matters, the particular individual (or individuals) within the firm who will work on the matter, whether the firm is likely to be able to meet any deadlines involved — as well as the likely cost. Given legal services status as experience goods, in reaching a judgment on likely value for money, it is clearly desirable for the procurer to be familiar with the work of firms in contention.

As Blunn and Krieger (2009: 16) observe, while legal services share some things in common with other professional-services markets:

> Providers of legal services have obligations beyond those owed to their clients — for example, obligations to the courts in litigation matters and professional, ethical and fiduciary obligations in all matters. This is so even if the 'client' is also the employer of the legal service provider in question. At its core, the relationship between client and legal service provider is one of trust and confidence, as is recognised by the special position given to it by law. That confidence depends largely on the knowledge, understanding and judgement of the service provider, often an individual.

Important determinants of the demand for legal services on the part of the Commonwealth (via its relevant agencies) could be expected to include:

- the sheer volume of legislation and associated regulatory instruments on the statute books;
- their complexity (leading to a need to obtain advice of various kinds — for example on how particular provisions of the law are likely to be interpreted by the courts);
- the contentiousness of particular pieces of legislation/regulation (which could be the subject of challenge of some kind);
- the willingness of aggrieved parties to mount such challenges (and their ability to do so in terms of necessary resources to do so);
- how often such challenges result in litigation involving the Commonwealth as an interested party, and the complexity of such cases; and
- how often the Commonwealth chooses to initiate litigation (or to invoke alternative dispute-resolution processes that involve legal input).

Blunn and Krieger (2009:22-3) elaborated specific factors that have boosted the Commonwealth's demand for legal services in recent years, including:

- The development and implementation of national competition policy pursuant to which former monopolies are either exposed to competition or regulated in a manner designed to emulate what would occur in a competitive market.
- The expansion of administrative law which has made government decision making far more transparent.
- A heightened awareness in the community of legal rights and natural justice requirements and the related development of well-informed and well-funded community and commercial bodies able and willing to challenge government actions.
- Moves of successive governments to transfer to the private sector a range of what were previously monopoly government services.
- Increasing numbers of significant property divestments, acquisitions or related transactions which often consume large amounts of legal services.
- Growth in regulatory authorities; for example, in the area of telecommunications, and the willingness of market participants to challenge regulatory authorities.
- Administrative law reforms of the late 1970s and early 1980s imposing significant legal responsibilities on agency heads.
- The FMA Act, which commenced on 1 January 1998, increased agency autonomy and the responsibility of agency heads in relation to agency-specific legal risk, resulting in a demand for continuously available and agency-specific legal services.

Sources of income of legal organisations

Although not focussed on demand for legal services on the part of the Commonwealth, the following Table is derived from ABS statistics on the sources of fee income of legal organisations in Australia. Although these figures suggest, for example, that Administrative/constitutional law work accounts for only 1.5 per cent of all fee income, there would be significant Commonwealth legal services work included in other sources of work enumerated in Table A1, including the property, environmental, intellectual property, industrial relations, commercial, personal injury and 'other' categories.

Table A1: Sources of fee income of legal organisations(a), 2007-08(b) (% of total income)

Source	2007-08
Property	
Conveyancing	11.9
Other	7.0
Wills, probate and estate activities	3.6
Family	6.4
Criminal	2.3
Environmental	1.8
Intellectual property	4.5
Industrial relations	4.3
Commercial	33.6
Personal injury	
Motor vehicle	2.5
Workers' compensation	2.8
Other	2.6
Administrative/constitutional law	1.5
Other fields	15.2
Total	100.0

Notes: (a) The ABS disaggregates legal service organisations into Barristers, Other legal services, Legal aid commissions, Community legal centres, Aboriginal legal services, Government solicitors, and Public prosecutors. The cost structures reported here are for Other legal services, which account for 85.2% of all persons employed across legal services. (b) Table percentages are derived from Table 3.1 of ABS (2009), *Legal Services, Australia, 2007-08* (reproduced at the end of this attachment).

Source: ABS (2009).

Legal services expenditure by the Commonwealth

According to the latest legal services expenditure report published by the Office of Legal Services Coordination (OLSC),[67] the total legal spend for FMA [68] agencies for 2009-10 was some $571.9 million (up 2.9% on the corresponding figure for 2008-09). With the corresponding estimate for CAC [69] agencies at an estimated $68.7 million (up 6.5% on 2008-09), the overall legal spend of the Commonwealth was some $640.6 million

[67] Commonwealth of Australia (2010), *op cit.*.

[68] Australian Government agencies to which the *Financial Management and Accountability Act 1997* (Cth) applies.

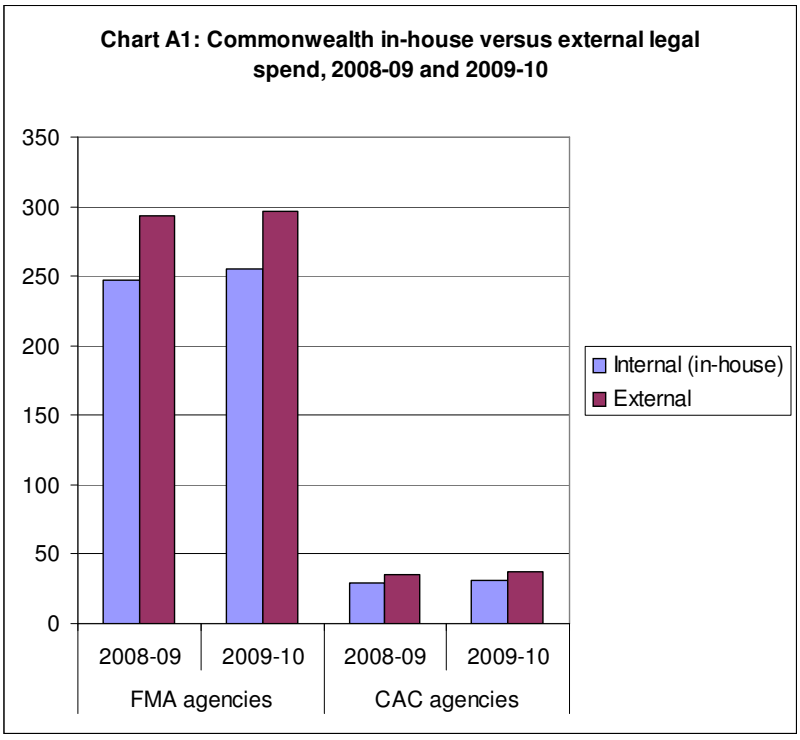
[69] Australian Government agencies to which the *Commonwealth Authorities and Companies Act 1997* (Cth) applies.

(up 3.3% on 2008-09 estates). Since prices for these kinds of services, as measured by movements in ordinary time hourly rates of pay (excluding bonuses) for *Private, professional, scientific and technical services* compiled by the ABS [70] rose by 3 per cent between the 2008-09 and 2009-10 financial years, the Commonwealth's legal spend in real (i.e. inflation-adjusted) terms rose only modestly (up by only an estimated 0.3% over the twelve-month period).

In-house versus external legal spending

Chart A1 compares estimated in-house (internal) with external legal spending by the Commonwealth (disaggregated into FMA and CAC agencies) for 2008-09 and 2009-10, based on agency reporting to OLSC. As is the case with overall spending, these components rose only modestly over the twelve-month period for both types of agencies, particularly in real terms.

Chart A1: Commonwealth in-house versus external legal spend, 2008-09 and 2009-10



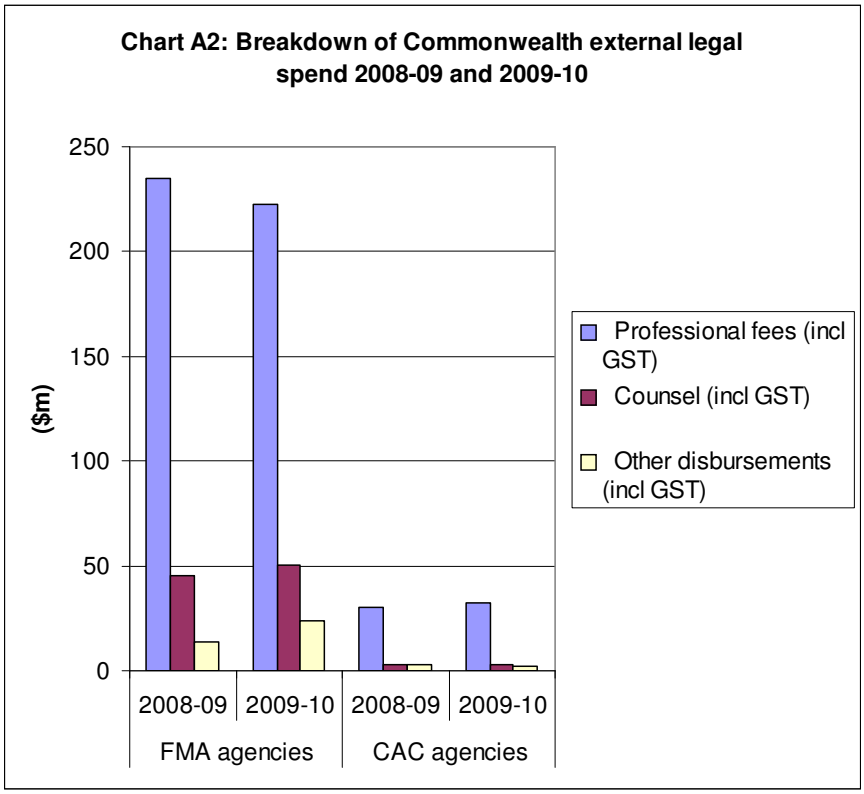
Source: OLSC, Legal Services Expenditure Report, 2009-10.

[70] ABS (2010), *Labour price index, Australia* (Cat. No. 6345.0).

Breakdown of Commonwealth external legal spending

Chart A2 breaks down Commonwealth external legal spending into professional fees, the cost of counsel and other disbursements for 2008-09 and 2009-10 (with the Commonwealth spend again split between FMA versus CAC agencies). In the case of FMA agencies, professional fees contracted somewhat over the twelve-month period, with other components either growing modestly or remaining flat.

Chart A2: Breakdown of Commonwealth external legal spend 2008-09 and 2009-10



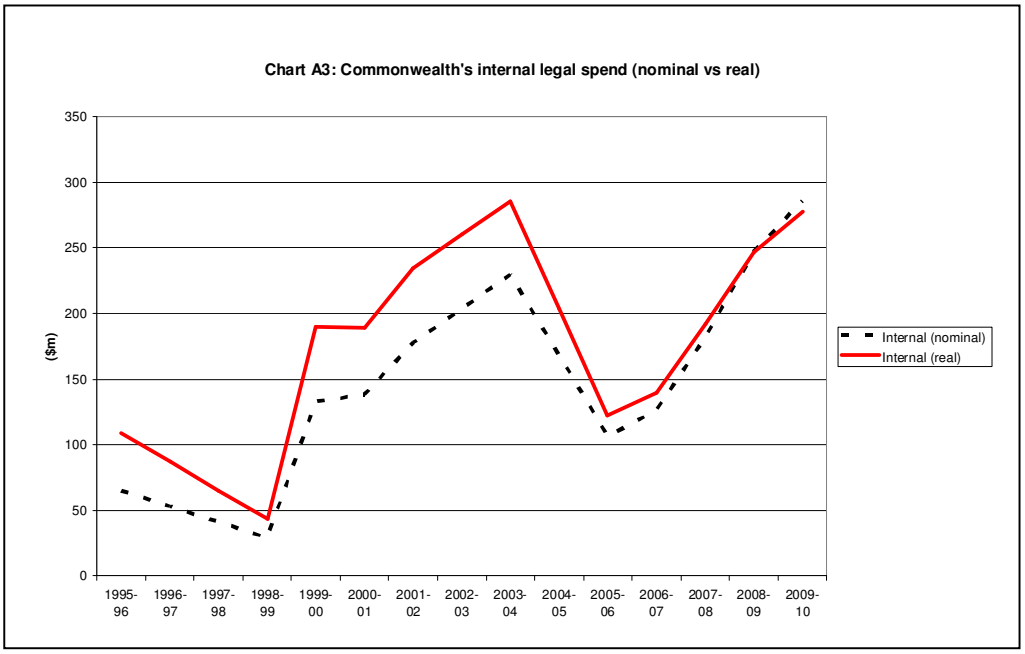
Source: OLSC, Legal Services Expenditure Report, 2009-10.

The top 10 FMA agencies in terms of overall legal spend in 2009-10 were (in order): ASIC, ATO, Defence (each with an individual spend exceeding $50 million in the financial year), DIAC, DoFD (including Comcover), ACCC and DEEWR (with spends in the range $20 to $40 million), Centrelink, DMO and FWO. Of CAC agencies only Comcare, CSIRO and Airservices Australia had spends exceeding $5 million — with Comcare by far the most significant, with a spend of almost $27 million (comparable with the DIAC/DoFD/ACCC/FWO grouping among FMA agencies).

Looking at the internal (in-house) component of the overall legal spend in 2009-10 in the case of both FMA and CAC agencies, roughly the same agencies come to the fore in terms of relative rankings. The notable exception is DEEWR, which is a relatively big in-house spender on legal services (joining ASIC, Defence and ATO in the $20 million plus internal spending league). Turning to the external component of the overall legal spend in 2009-10 in the case of both FMA and CAC agencies, again the same agencies tend to be the big spenders (namely, ATO, ASIC, DoFD, ACCC, Defence, DIAC and Comcare — each of which spent more than $15 million in 2009-10 on external legal services.

Trends in Commonwealth legal spending over time

Turning to the Commonwealth's legal spend over time, Chart A3 plots its estimated internal legal spend over the period 1995-96 to 2009-10 in both nominal (dollars of the day) and real (inflation-adjusted) terms. Chart A4 does the same thing for the Commonwealth's external legal spend. However, as Blunn and Krieger (2009:21) note, the data suffer from inconsistent definitions and questionable coverage over time.

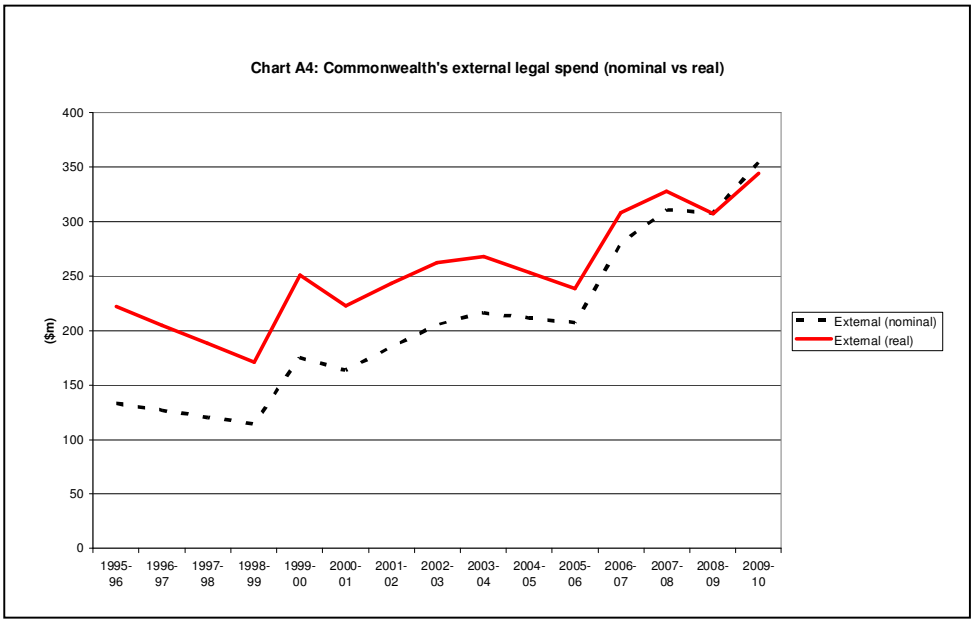


Notes: Nominal (i.e. dollars of the day) estimates for 1995-96 through 2008-09 come from the Blunn-Krieger report while nominal estimates for 2009-10 come from OLSC's *Legal Services Expenditure Report 2009-10*. Real (i.e. inflation-adjusted) estimates use ABS's Financial year indexes for ordinary-time hourly rates of pay (excluding bonuses) for private professional, scientific and technical services for Australia as a whole as the chosen deflator.

Sources: Blunn & Krieger (2009), OLSC (2010 and ABS (2010).

There were a few missing observations in both series, which have been linearly interpolated to enable average annual growth rates to be

calculated and complete series of observations graphed.



Notes: Nominal (i.e. dollars of the day) estimates for 1995-96 through 2008-09 come from the Blunn-Krieger report while nominal estimates for 2009-10 come from OLSC's *Legal Services Expenditure Report 2009-10*. Real (i.e. inflation-adjusted) estimates use ABS's Financial year indexes for ordinary-time hourly rates of pay (excluding bonuses) for private professional, scientific and technical services for Australia as a whole as the chosen deflator.

Sources: Blunn & Krieger (2009), OLSC (2010 and ABS (2010).

Bearing in mind the caveats surrounding the underlying data, the notable thing to come out of this analysis is the comparatively greater growth in the Commonwealth's internal legal spend, which grew on average by 23.3 per cent per year in real terms over the period. This compares with an equivalent figure of 4.2 per cent per year in the case of the Commonwealth's external legal spend, and 7.9 per cent per year overall. These are high real growth rates sustained over an extended period (15 years), and especially so in the case of Commonwealth internal spending on legal services (although as mentioned, it is unclear the extent to which this is an artefact of changes in methodology/coverage of the figures).

Private law firms' perspectives on Commonwealth external legal spending

Commonwealth demand for legal services dominates the work done in most Canberra Offices of private law firms which do work for Australian Government agencies. Similarly, most of the work done for the Commonwealth is done in Canberra. Nevertheless Commonwealth work

typically only accounts a modest proportion (e.g. 10% or less) of firms' total revenues arising from the demand for legal services in general. Given a generally high dependence on Commonwealth legal work in the case of firms' Canberra offices, firms advised that any substantial loss of such business would threaten the viability of such offices.

Asked about the relative importance of panel-related versus other sources of Commonwealth legal-services work, firms indicated that work on panels dominated. This underscores the importance of the phenomenon of panel formation when it comes to bidding to satisfy the demands of the Commonwealth for external legal services.

When it comes to panels, firms held varying views on whether agencies place more emphasis on firms' reputation (the 'brand') versus the individuals/teams working within them (who would actually be doing the work) when it came to deciding which panel members would be chosen (or chosen to compete for) what work. The general perception centred on equal weightings as between these two variables. However, when it came to when the bargaining was keenest, firms generally thought it was toughest at the panel-formation stage rather than after panels were formed. However, once panels were formed the amount of 'mini-tendering' among panel members for particular pieces of work was reported by firms to vary markedly among agencies – with some reportedly routinely adopting this practice for all panel work.

On pricing, some private law firms expressed interest in moving from a fee-for-service arrangement to a fixed fee for a guaranteed volume of work (with both parties monitoring value for money within such an arrangement).

The Catalyst Benchmarking Report [71]

Following up a 2008 report ACLA, CLANZ and Team Factors pulled together data from the general counsel and legal managers of some 160 organisations [72] operating in more than 30 industries to produce its 2010 benchmarking report on legal services spending in both Australia and New Zealand. Salient points to emerge from the report in respect of Australia were that:

- The public/private sector split was 27 per cent versus 73 per cent.

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[71] Catalyst/teamfactors (2010), *op cit.*.

[72] Participating Australian Government agencies included Airservices, AGD, Australia Post, ABC, Australian Customs and Border Protection, ATO, CSIRO, DEEWR, DHA, DHS, DIAC, DIIRD, and the Treasury.

- The average legal spend as a percentage of revenue/turnover was 0.46 per cent.[73]
- Of 21 areas of specialisation,[74] those that accounted for an average of 10 per cent or more in terms of hours spent by legal departments were Contract/commercial (29%), Energy/resources (18%), Public/administrative law (16%), Litigation/arbitration/alternative dispute resolution (13%) and Corporate/company (11%).
- Of the 21 areas of specialisation, those that accounted for relatively higher percentages of external legal fees were Litigation/arbitration/alternative dispute resolution (31%), Banking and finance/capital markets (24%), Energy/resources (20%), Contract/commercial (20%) and Property/construction (20%).
- Consistent with 2008 findings, legal departments continued mostly to outsource complex legal work, in particular in the areas of Litigation/arbitration/alternative dispute resolution, Tax, Banking and finance/capital markets, and matters involving international law.
- In the case of routine matters, outsourcing was most pronounced in the Tax and Litigation/arbitration/alternative dispute resolution areas.
- The most prevalent monitoring tools and metrics reported by legal department respondents were (in order) Monitoring total annual legal spend, Monitoring of legal costs versus budget (quarterly/annually), Recording of the number and type of legal matters, Monitoring legal costs versus budget per matter, Regular end-of-transaction assessments, Monitoring of effective billing rates per firm, Monitoring of the ratio of in-house to outside legal costs, Monitoring of effective billing rates per transaction, Time recording

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[73] The corresponding metric for Commonwealth legal work on the part of individual agencies would be the annual legal spend expressed as a proportion of agencies' annual budgets. Although such a measure would vary considerably agency-by-agency (with some being 'legal intensive'), at the aggregate level a legal spend of $640 million in 2009-10 represented 0.12% of total budgeted outlays of the Commonwealth in that year (of some $338.2 billion).

[74] Nominated areas of possible specialisation were Contract/commercial, Energy/resources, Public/administrative law, Litigation/arbitration/alternative dispute resolution, Corporate/company, Regulatory, Banking and finance/capital markets, Property/construction, Mergers and acquisitions, Communications/media/entertainment, Competition/fair trading, Employment/workplace relations, Intellectual property/patents/trademarks, IT/e-commerce, International law, Environment, Insurance, Occupational health and safety, Creditors remedies/insolvency/bankruptcy, Privacy and Tax.

and Monitoring of legal costs as a percentage of revenue/turnover.[75]

- Public sector respondents were less likely than their private sector peers to have achieved cost reductions over the past two years (46% reporting no significant reduction versus 32% of their private sector counterparts).
- The median number of law firms used in the past year was 5-9 (as in 2008), with a significant majority using 3-9 firms — with no appreciable difference as between the public and private sectors.
- When respondents were asked what best described their organisation's use of law firms, more than one-third (36%) reported use of a formal panel (2008, 32%), yet those without panels mostly use preferred forms for certain types of work (34%; 2008, 41%) — with another 21 per cent mostly using one or two main firms (2008, 17%). Among those with panels, 77 per cent select firms for certain types of work without further competition among panel members for major transactions (2008, nearly 80%). A majority of public sector respondents (54%) select panel members by a competitive tender process open to any firm that chooses to participate, while no private sector respondents did so, instead deploying competitive tender processes to selected firms (or a less-formal process involving the selection of firms based on assessed organisational expertise and experience).

A3 Supply

The demand for Commonwealth legal services is satisfied by a combination of dedicated agencies (such as the Attorney General's Department (AGD) and the Australian Government Solicitor (AGS)), individual agency in-house legal teams and external suppliers (i.e. private law firms).

So called 'tied work' (e.g. constitutional, cabinet, national security, public international law and most drafting work undertaken for Australian Government agencies) is undertaken by dedicated agencies such as the AGD or the AGS. Other work is, at least in theory, contestable by the private sector — but agencies may decide to have work done within the agency (if they are sufficiently big to justify the resources involved in operating 'in-house' legal services).

[75] Remarkably (the authors note) the same top 10 factors featured in the 2008 report (and in the same order).

Since 1 September 1999, apart from tied work agencies have been able to choose how their legal needs are to be met, and at what cost.[76] As a result, a number of legal services 'models' now operate across Australian Government agencies. The most common involves an in-house team with access to one or more external providers (e.g. via a panel of pre-approved suppliers), although some agencies have elected to fully outsource their legal services function.

Because individual agencies can be responsible for quite specific pieces of legislation, they have an incentive to form panels which include legal organisations which are intimately familiar with the interpretation and application in specific instances of what can be highly complex (and specialised) areas of law. At the other end of the spectrum can be high volumes of routine matters that have effectively become 'commoditised' areas of the law (where cost control is of paramount importance in agencies securing value for money).

The counterpart of Table A1 on the demand side, Table A2 disaggregates the cost structure of legal organisations into significant components for 2007-08.

[76] Agencies generally have to comply with Legal Services Directions (LSDs) prepared by the Office of Legislative Drafting and Publishing (OLDP) of the AGD, which aim to ensure delivery of efficient and effective services.

Table A2: Cost structures of legal organisations [(a)], 2007-08 [(b)] (% of total expenses)

Type of expense	*2008-09*
Wages and salaries	36.9
Other labour costs	6.8
Payments for:	0.0
Legal services	5.2
Legal support services	15.0
Rent, leasing and hiring	7.3
Insurance	2.8
Professional and other services	26.0
Total	100.0

Notes: (a) The ABS disaggregates legal service organisations into Barristers, Other legal services, Legal aid commissions, Community legal centres, Aboriginal legal services, Government solicitors, and Public prosecutors. The cost structures reported here are for Other legal services, which account for 85.2% of all persons employed across legal services. (b) Table percentages are derived from Table 3.1 of ABS (2009), *Legal Services, Australia, 2007-08*.

Source: ABS (2009).

Based on ABS-compiled information from 2007-08, the items Rent, leasing and hiring and Insurance together account for around one-tenth (10.1%) of total costs. This figure from the private sector could be used to generate fully costed estimates for in-house legal services where it may be difficult to derive an estimate to cover these components of overall costs. As a matter of principle, a similar adjustment should also be made for items like payroll taxes (and other taxes) incurred by private law firms but generally not taken into account in costing in-house legal teams. Making such adjustments would aid comparisons — which otherwise could be expected to favour use of in-house legal services over private sector counterparts (on cost grounds). Nevertheless there are a range of practical matters which require attention before one could conclude that such a policy should be pursued. These are discussed in the body of the report.

Tendering costs

In January 2011, OLSC circulated a survey from Lateral Economics asking both purchasers (government agencies) and providers of legal services (private law firms and the AGS) about a range of matters, including the significance of tendering costs for panels in relation to the value of work commissioned through them.

We were interested in two basic panel-related summary metrics: purchaser and provider tendering costs as a proportion of the value of work commissioned through a panel over the life of that panel.

For purpose of comparison estimates of recent panel-related tendering costs was available from Victoria.

Purchaser tendering costs

Agencies reported an average cost to themselves of establishing a panel of $120,000. Estimated agency costs as a proportion of work done by the resulting panels worked out at around 0.85 per cent, while the average set-up cost would imply a total cost of around $8.6 million to set up 72 panels each of which would typically last for three to five years. There a range of caveats here. The costings of panels were highly variable, and ranged from costings which appeared very low and unlikely to fully account for the opportunity cost of resources to a costing which was a costing for a future panel which appeared surprisingly costly. Further, our average is somewhat weighted against smaller panels, and we have evidence that the cost of establishing them is lower in absolute terms than larger panels, albeit a larger fraction of total panel expenditure. On the other hand, given descriptions of what is involved in establishing a panel, we also suspect that reported agency costs underestimate the true resource costs of establishing panels.

Since the value of work done by panels varies widely by agency cost per panel will also exhibit similar variability. For example, at one end of this cost curve $5,000 spent to set up a panel which ends up doing $100,000 worth of legal services work would represent 5 per cent of the total, whereas $65,000 spent setting up a $45 million panel would represent 0.14 per cent of the overall value of work done by the panel.

By way of comparison the Victorian Department of Justice incurred costs of around an estimated $550,000 in setting up panels with a projected 2010-11 expenditure of some $57 million. This appears to imply a ratio of 0.0096 in terms of provider tendering costs as a proportion of the value of panel work available, however this ratio would fall to around 0.0024 (or 0.24% compared with 0.85% for the Commonwealth) assuming the Victorian panels last for 4 years (as is typically the case).

Provider tendering costs

Given the timing of our study (taking in the New Year break), Lateral Economics has had to estimate provider tendering costs from a limited number of responses to its survey.

Provider costs of bidding to be on panels ranged from $2,500 to over $150,000 with the average around the $10,000 mark. And with some panels attracting 20 bids or more,[77] such panels would involve providers

[77] We were advised, for example, that one $5 million panel attracted 19 bids while another for around $15 million of work annually drew 25 bids. Other examples suggested that, other

incurring $200,000 plus in bidding costs.[78] However, the average provider cost per panel could be expected to be significantly lower that this figure, estimated to be of the order of $100,000.

To put these estimates in perspective, the Victorian Department of Justice estimated provider tendering costs between $100,000 and $350,000 (depending on the number of panels firms chose to tender for). So six-figure amounts in terms of provider costs — either in terms of overall bidding costs for panel formation or in terms of bidding costs to get on panels on the part of some firms — would not be unusual in the case of larger law firms wishing to supply legal services to governments in volume. So with provider costs likely averaging $100,000 per panel, the implied total cost to set up 72 panels would be $7.2 million. This figure is nevertheless consistent with a quite modest tendering costs expressed as a proportion of work won in a year (see below).

Estimated provider costs as a proportion of work done by the resulting panels worked out at around 1.4 per cent, based largely on survey responses from large law firms.[79] We know that AGS plus the leading 9 private law firms together account for around 90 per cent of the Commonwealth's external legal spend (see next section). However, smaller firms could be expected to incur much higher tendering costs in relation to work won, and this would boost the 1.4 per cent estimate. And, indeed, that is the case based on survey returns from small firms whose tendering costs in relation to work won typically exceeded 10 per cent (see Chart A5 which depicts typical ranges for these proportions as between small and large firms). Thus our estimate of the cost of tendering as a proportion of work won would be around the 3 per cent mark.

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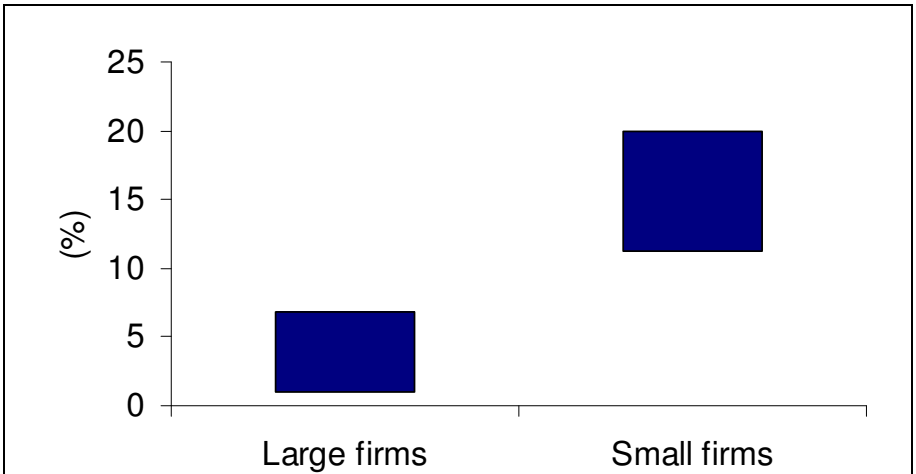
things equal (but see following footnote), the more work was on offer the greater the number of bids likely to be forthcoming.

[78] However, the number of responses tenders for panels are likely to elicit can be constrained by criteria incorporated into tender documents (e.g. requirements that bidding firms be not only full-service but have an office in Canberra). Thus, although high-value panels could be expected to attract high numbers of bidders, this may not necessarily be the case.

[79] In arriving at this overall estimate, individual estimates from two firms were treated as outliers - both high and low - and their contributions to the overall figure replaced by the next highest and lowest values, respectively.

Chart A5: Range of tendering costs as a proportion of panel work won: large versus small firms



Source: Lateral Economics survey and calculations

Nevertheless, as with purchaser tender costs, provider tendering costs as a percentage of panel work won varied significantly.

Purchaser and provider tendering costs

Summing purchaser and provider tendering costs as a proportion of annual work available yields an estimate of around 3.85 per cent (equivalent to around $9.8 million with estimated annual panel work of some $255 million).

And with estimated purchaser costs of setting up existing legal panels at some $8.6 million and provider costs at an estimated $7.2 million, the resulting $15.8 million in panel-related costs for both purchasers and providers represents a significant commitment of resources.

The reforms proposed in this report would reduce the number of panels by at least two thirds if not three quarters or more, though all these panels would be substantial. Assuming this reduced tendering costs as a proportion of annual work available by 50 to 75 per cent this would lower costs by between $5 and $7.5 million (in round numbers) annually.

External supply of legal services to the Commonwealth

Professional fees

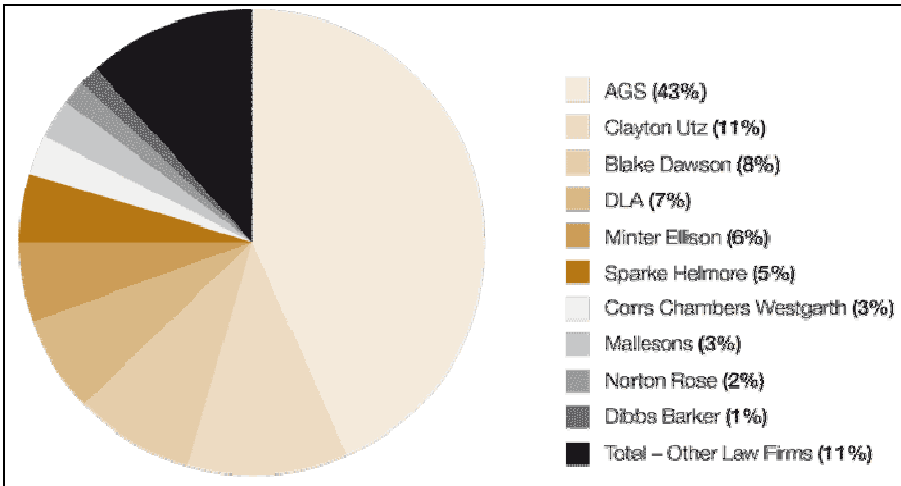
According to OLSC, in 2009–10, FMA and CAC agencies paid a total of $254.9 million in professional fees to law firms, with the top 10 firms receiving approximately 89 per cent of that total. And from the detailed

returns, it would appear that the overwhelming majority of these fees were panel-related.

Some 250 odd legal services providers were identified in agency reports as providing legal services to the Commonwealth. AGS was the leading external provider, accounting for 43 per cent of professional fees earned by external law firms (treating the AGS as such), followed (in order) by: Clayton Utz (11%); Blake Dawson (8%); DLA Phillips Fox(7%); Minter Ellison (6%); Sparke Hellmore (5%); Corrs Chambers Westgarth (3%); Mallesons (3%); Norton Rose (2%); Dibbs Barker (1%); and the rest (11%).

With Dibbs Barker (the smallest of the top-10 external providers) only accounting for 1% of the Commonwealth's external legal spend, supplying legal services to the Commonwealth is dominated by large players. As mentioned, OLSC calculated that the top-10 external suppliers of legal services to the Commonwealth accounted for 89 per cent of the overall spend.

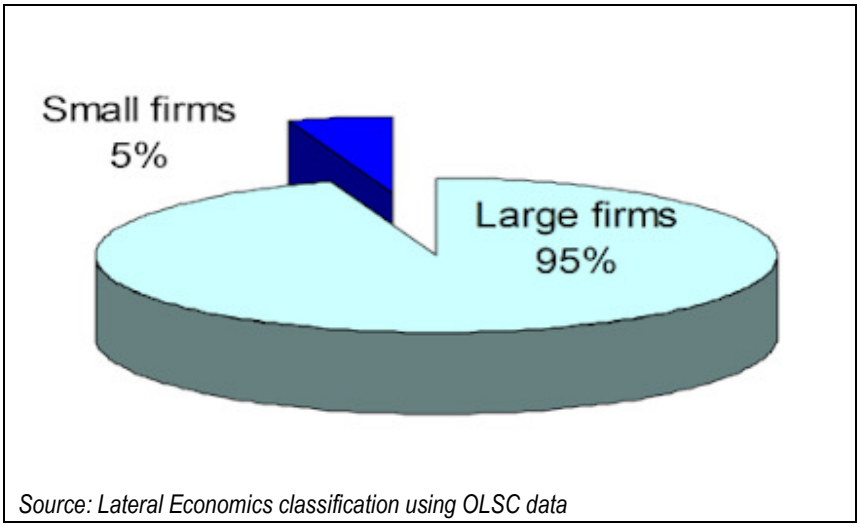
Chart A6: Share of Commonwealth spending on external legal services (professional fees), 2009-10.



Source: *Legal Services Expenditure Report 2009-10*

Lateral Economics scoped the split of expenditure on firms qualifying as small to medium sized enterprises under the CPGs using data supplied by OLSC. The data was broadly consistent with the data in the OLSC Legal Services Expenditure Report though there may have been some small differences. Given the time available we were unable to confirm the size of all 253 firms recorded in the data. However performing internet searches where possible and where we were unsure, erring on the side of classifying firms as small rather than large, we estimated the amount spent on firms with fewer than 200 employees was 5 per cent.

Chart A7: Proportion of small and large firms supplying legal services



Source: Lateral Economics classification using OLSC data

Counsel

According to OLSC, in 2009-10 FMA and CAC agencies paid a total of $53.2 million to counsel, consisting of 2821 briefs. This represented an increase of $5m over the 2008–09 reporting period, in which FMA and CAC agencies paid a total of $48.2 million to counsel consisting of 2280 briefs (at an average value of $18,900 compared to $21,000 in 2008-09).

Further, in 2009-10, FMA and CAC agencies reported 767 briefs to counsel on a direct brief basis (an increase of approximately 490% from the previous reporting period, in which FMA and CAC agencies reported only 130 direct briefs to counsel).

A3 Other survey results

Importance of Commonwealth legal services work

Asked about the importance of securing Commonwealth work for their Canberra Offices (in cases where they had one), most (but not all) private law firms indicated that such work dominated (sometimes 90%+) legal services work done locally – with most work done in Canberra rather than outsourced to other offices. Nevertheless, Commonwealth work typically only represents a modest proportion (often less than 10%) of the total billings of private law firms (consistent with Table A1 above). Unsurprisingly, AGS is virtually totally dependent on the Commonwealth for its revenues.[80] Most firms indicated that it would be a struggle to find

[80] section 55N of the Judiciary Act 1903 restricts AGS largely to acting for the Commonwealth with only a few exceptions.

other work for their Canberra offices should available Commonwealth work decline significantly. A typical response to our question on this matter was that any substantial loss of Commonwealth work would threaten the viability of firms' local presence in Canberra.

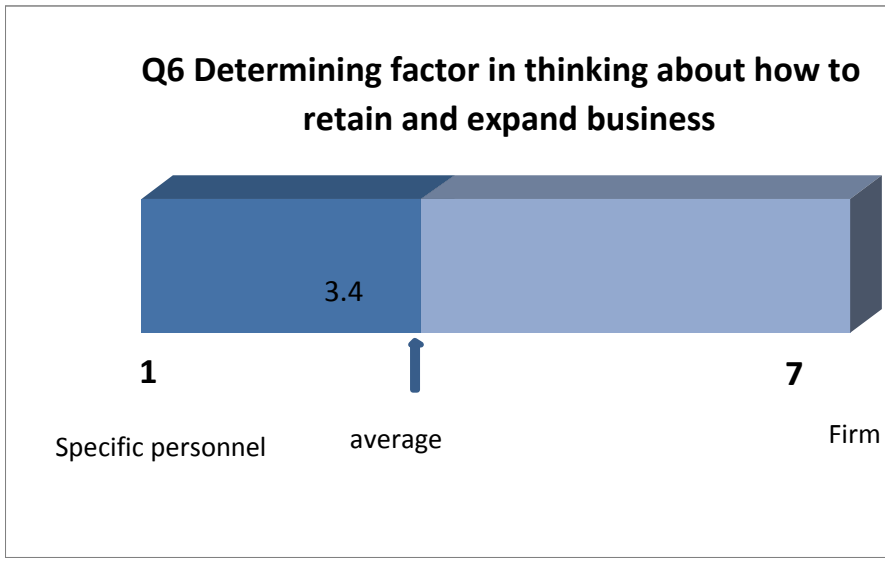
Relative importance of panel versus non-panel work

Most firms nominated an 80:20 split of Commonwealth work as between panel and non-panel provision of legal services. This underscores the predominance of panel formation as a method of satisfying agencies' demands for external legal services. Nevertheless a small portion of Commonwealth demand for external legal services is satisfied outside the panel model as a mechanism for allocating such work to outside providers.

Firms indicated that further tendering within panels for particular work (mini-tendering) was highly variable between agencies – with some calling for further bids for virtually all of their panel work, while others made modest use of mini-tenders.

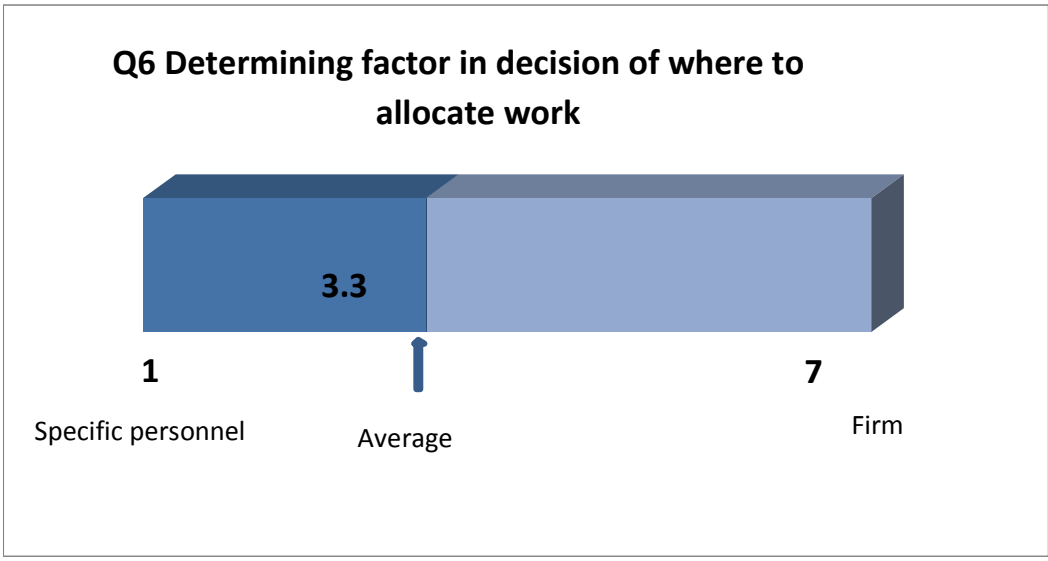
Targeting of people rather than firms

Asked whether specific personnel were more important that firms' reputation in seeking to retain and expand business (Survey Q6 for firms) firms offered varying responses – with the weight of opinion favouring personnel over the firm's reputation in the marketplace (see graphic below).



Source: Lateral Economics survey

Asking the same question of agencies also drew varied responses, but with a remarkably similar average response favouring people over firms

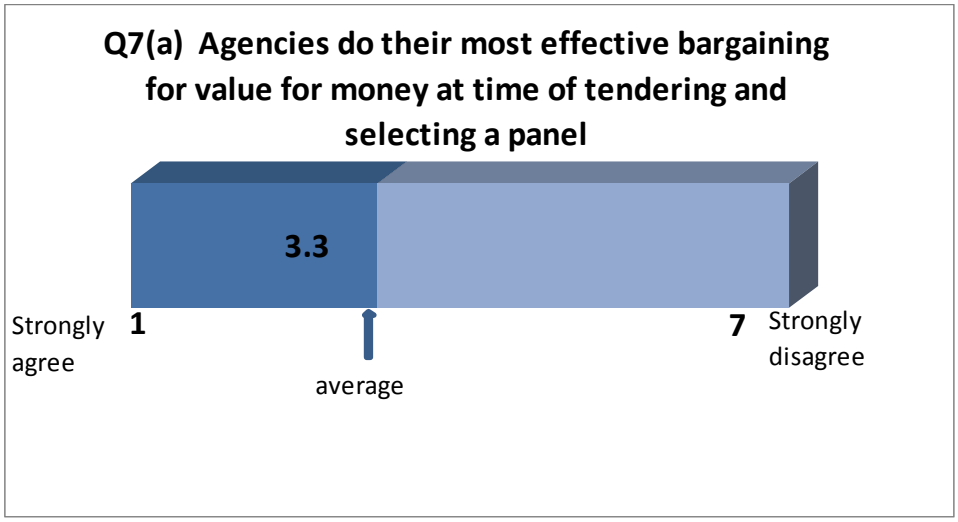


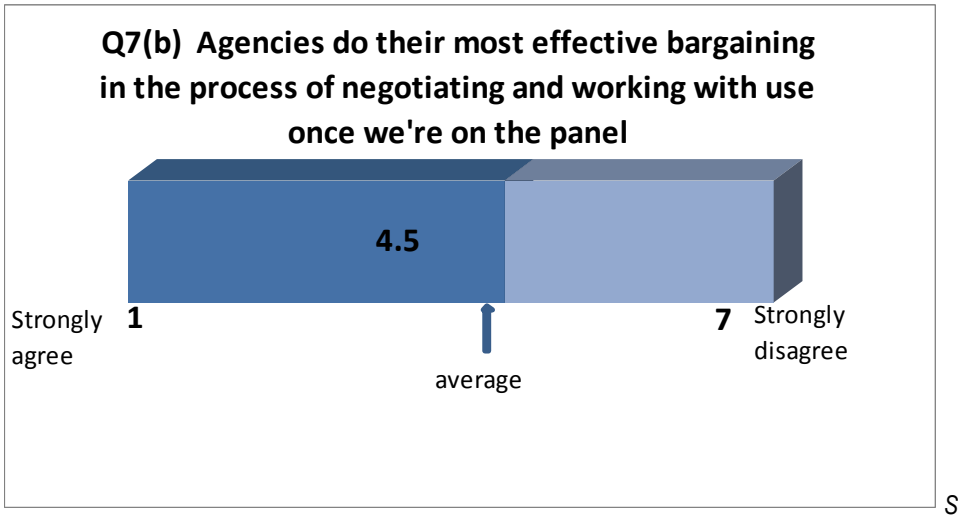
Source: Lateral Economics survey

Bargaining pre- and post-panel formation

Views were similarly mixed over whether firms judged bargaining with agencies (e.g. on hourly rates) as keenest when panels were being formed or afterwards when work was being awarded to panel members. An impression gained from the answers (see graphics below) was that survey responses seemed to depend on the particular agencies respondent firms dealt with (and in particular the extent to which they conducted further mini-tenders for panel work).

Firms commenting on bargaining





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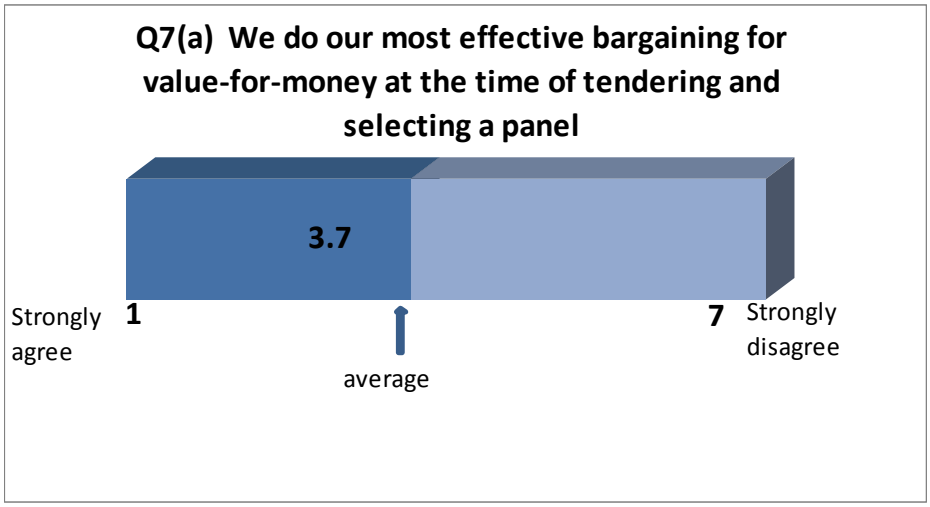
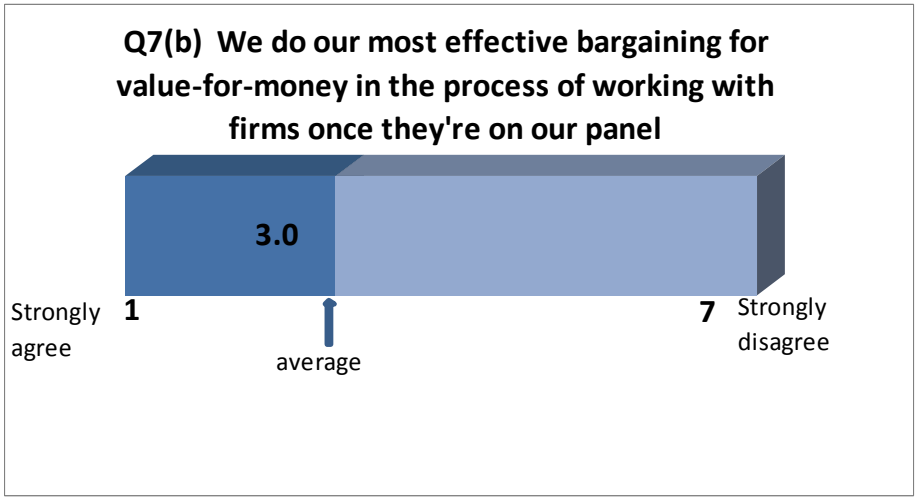
ource: Lateral Economics Survey

Asking agencies when bargaining was keenest also drew and range of responses, with opinion favouring post-empanelment period as when the keenest bargaining occurs. Again, such judgments may be explained by the use (or not) or mini-tendering for panel work.

Agencies commenting on bargaining





Source: Lateral Economics Survey

Appendix B: Analysis of legal panels

B1 Introduction

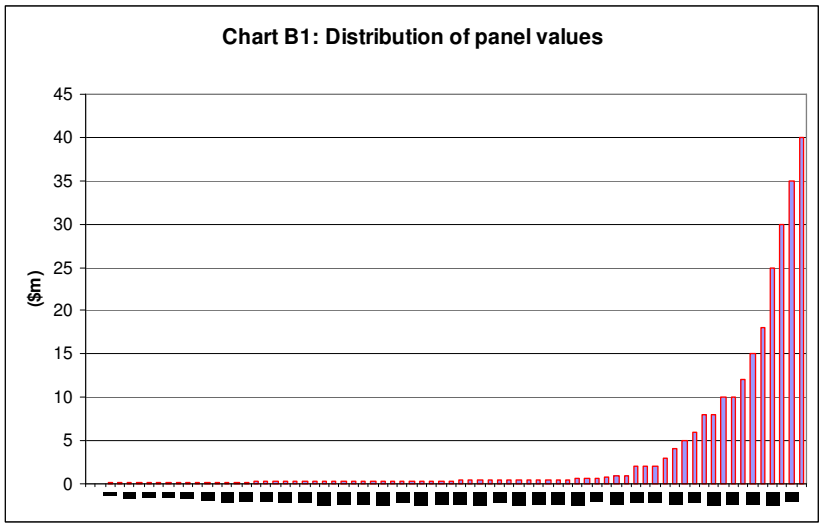
The purpose of this appendix is to conduct an analysis of legal panels based on what information is known about them (see Attachment A) in order to provide insights into how best the existing arrangements might be reformed so as to:

- Better ensure that the Commonwealth obtains value-for-money when Australian Government agencies purchase legal services;
- Better leverage the Commonwealth's purchasing power to drive costs down and quality up; and
- Better empower relevant agency decision makers to fulfil their role as informed purchasers of legal services.

B2 Leveraging what is known about legal panels

Working from the following 'stylised' facts about legal panels, namely that there are some 72 know to exist (with some agencies having multiple panels), that the external legal spend is running at around the $255 million mark (with the preponderance of spending being done through panels) and that the top 10 legal firms account for approximately 90 per cent of the Commonwealth's external legal expenditure, then the charts below depicts distributions of Commonwealth legal panels and firm shares of panel work that are consistent with the available evidence on panel size and the relative importance of firms in responding to Commonwealth's external demand for legal services.

Chart B1: Distribution of panel values



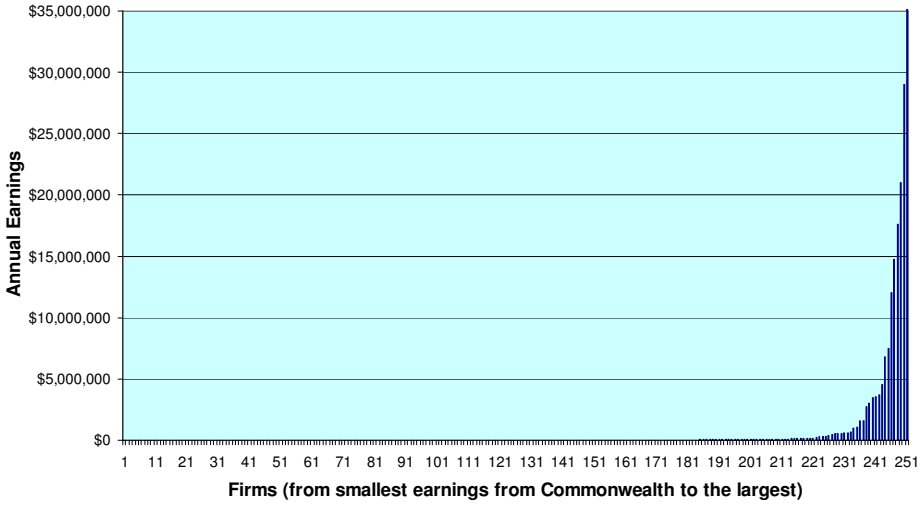
In Chart B1, the annual amount transacted through each panel is displayed on the vertical axis, with information on the largest panels based on what is know about their estimated annual spends and the rest of the panels inferred so as to conform to total panel spending. The long tail of this distribution means that, while the average panel size involves around an estimated $3.4 million annual spend, the median spend (the point where there are as many panels of greater value as smaller ones) is estimated to be around the $300,000 mark.

Most of the long left tail of this distribution has been interpolated to conform to what few facts about panel sizes are available to us, so it is not until panel sizes reach around the $1 million mark that the distribution is based on firmer information.

The distribution also emphasises the lack of any leverage available to the vast majority of agencies whose legal spend is modest compared to those (relatively few) agencies with annual spends of (say) $20 million or more. In turn this suggests that the legal-services needs of a substantial majority of government agencies could be met at a lower cost via a multi-user list, or specialist panels, supplemented by access to an 'informed purchaser' (e.g. someone in one of the large-spending agencies well versed in how to secure value-for-money from potential legal services suppliers making the multi-user list or appropriate specialist panel).

The distribution of firm shares of panel work allocated in a year is similarly highly skewed as illustrated in Chart B2 with the top-10 accounting for 89 per cent of all panel work done, leaving just 11 per cent to be shared by all other firms supplying legal services to the Commonwealth. As was the case with the distribution of panel sizes in Chart B1, there is a very long tail of very small firm shares.

Chart B2: Distribution of earnings from Commonwealth for legal services providers



Source: Data from OLSC: Note AGS's earnings would be represented by a line stretching to a point above three times the height of the 'Annual Earnings' axis (or 'y' axis).

B4 Panel types

Several points emerge from what legal panels must look like. The most notable is how panels fragment the market for Commonwealth legal services. For example, based on information supplied by OLSC it is apparent that the top-10 providers of legal services to the Commonwealth generate their revenues from many individual agencies, with the number correlated with their market shares (see Appendix A). That is, the higher the market share of Commonwealth work won by a firm, the higher tends to be the number of agencies that firm bills in a year in order to generate that market share. The average number of agencies the top-10 providers generated revenue from in 2009-10 was 42, with a significant variation around this mean. . Thus, the 72 panels in existence have the effect of fragmenting the market to such an extent that it is a relatively rare event for any of a top-10 provider to be in a position to bill any one agency of the Commonwealth for work worth more than $1 million in a year – with the overwhelming majority of the legal service work done for the Commonwealth involving annual billings of far less than that.

Appendix C: Competitive neutrality

Since relatively early in the reform period the Commonwealth has been cognisant of the equity and efficiency implications of non-neutralities of treatment between public and private agencies competing in the same market. In particular private firms pay payroll and company tax whilst Commonwealth public agencies generally do not.

As a result, the Commonwealth's competitive neutrality policy requires agencies that are in direct competition with the private sector to make payments which simulate the payments they would have to make if they were a private firm. There are issues in deciding where the line should be drawn in requiring competitive neutrality to be applied. AGS makes competitive neutrality payments because it is seen to compete with private firms, even though it does not compete against them in the private legal services market. Guidance to agencies – for instance from the ANAO (2006) – on internally costing the provision of in-house legal services can be helpful in delivering competitive neutrality by encouraging agencies to look at the full cost of service provision, rather than just its immediate marginal cost. Accordingly the ANAO suggests that agencies to fully account for fixed costs such as rent, IT overheads and so on (See box below). But it does not suggest agencies make any allowance for taxes that they would pay if they were a private firm but are not required to pay as a Commonwealth agency.

Box C1: Case study – costing legal services

[A]n audited agency costed its internal legal services and developed charge-out rates for its internal lawyers using a model that included salary, a loading for salary-related expenses and variable, or direct, overheads and fixed, or indirect, overheads.

The salary rates reflected the relevant salary points (from the agency's workplace agreement), and levels of staff. This enabled the agency to calculate the full cost, as well as apply an hourly rate, based on a specified level of 'billable' hours per year. . . .

The result . . . was that an internal legal resource could be fully costed, as well as the 'marginal cost' per hour/day for work that could be given to external providers. . . .

The salary-related loading was based on 25 per cent of salary for each staff member, to make provision for superannuation and long service leave, etc.

The variable overhead included the provision of IT, professional development and workers' compensation insurance (the agency's average contribution per employee to Comcare).

The fixed overhead included the total estimated cost of the provision and maintenance of the legal unit's law library, administrative support staff, apportioned costs of accommodation and rent, furniture and fittings, communications (phone and facsimile), office expenses (stationery, photocopiers, consumables, etc), travel, and a provision for annual recruitment costs for the legal unit.

The ANAO considered that this costing model represented a comprehensive and appropriate approach to assessment of that agency's internal legal costs.

ANAO, 2006, p. 25

There is an important competitive neutrality issue here. Taxes are paid in the private sector and payments in lieu of taxes are paid by AGS, yet agency legal practices seek to allocate work on the basis of optimising value for money *to the agency*. This effectively gives the internal service the advantage of the tax that it does not pay. We discussed this matter with the Department of Finance and Deregulation and verified that the current demarcation of the competitive neutrality policy means that it does not generally apply to the decision within an agency of whether or not to purchase in-house or to out-source.

In principle this decision is every bit as capable of adversely affecting resource allocation decisions as a lack of competitive neutrality anywhere else. However there are two important practical questions.

Firstly the benefits of pursuing competitive neutrality in a more thoroughgoing manner could exceed the administrative costs of doing so. If agencies were required to make elaborate provision to calculate competitive neutrality payments, the effort to do so could outweigh what would be relatively small benefits. If this were the only problem we would propose that some simplified means of applying competitive neutrality be applied. For instance one could impose a simple rule of thumb that agencies impute a tax cost of around 6 per cent of their other costs – the precise figure might be benchmarked against the relative cost of competitive neutrality payments by AGS – and require agencies to apply this rule.[81]

However to make such a policy incentive compatible so that agencies incentive to minimise their own operational costs was consistent with them behaving in a way that was competitively neutral, one would need to make compensating additional payments to agencies in introducing the policy. If this worked according to the in-principle observations here, with full compensation, there would be a small dividend left over for agencies. They would slightly increased their outsourcing in response to the changed cost relativities of in-house and out-sourced legal services and so save some money. (The alternative is that departments are not fully compensated and the 'dividend' from reform is captured centrally.)

However this would lead to a substantial rearrangement of payments to and from central agencies and it is quite possible that this would have its own costs or potential costs. Further these issues are not limited to the out-sourcing of legal services. They are in principle the same wherever agencies make decisions at the margin about what services they will out-source and what they will keep in-house.

For these reasons we have not made any recommendations for change here. However in exploring the issue, it seemed to us that it would be worthwhile for the issue to be reviewed by the Attorney General's Department and the Department of Finance and Deregulation with a view to exploring the practicability of extending competitive neutrality principles into at least those areas in which agencies are making large resource allocation decisions between the public and the private sector – for instance in situations where agencies out-sourced over 30 per cent of their legal services. At the Government wide level this is a job for Finance predominantly, but we suggest the Attorney General's Department be involved in case legal services could be a worthwhile candidate for trial of a system which might be rolled out more generally depending on the success of such a trial.

[81] The figure of 6 per cent was estimated from the financial statements in AGS's Annual Report, but not further verified by discussion with AGS.