

Poor governance design: Its impact on transaction costs and value creation.

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Poor governance design:
Its impact on transaction costs and value creation.

Abstract

We argue the hierarchical nature of contractual governance within outsourced services is not effective, consequently increasing transaction costs for the Buyer and Supplier, and reducing value in use.

We studied outsourced public sector Repairs and Maintenance (R&M) contracts considering the contracts within the relational exchange and their role in governing and directing the delivery of services. A key feature is delivery via a Value network, Buyers and Suppliers outsourcing elements of procurement and service delivery. Within this sector, the use of construction influenced standard forms of contract and traditional performance measurement regimes utilising temporal and volumetric metrics are endemic.

Our findings demonstrate that the relationship between contractual governance and measurement is a traditionally held perspective of output and operand resources. Additionally the forms of contract create a disconnect to the governance objectives sought, exacerbates transaction costs and diminishes “value in use” for the Resident.

Key words

Transaction costs, Service quality, Value in Use, Value in exchange, contract governance, outsourcing, performance measurement, KPIs, procurement, goods-dominant logic, service-dominant logic, Value network, OJEU, Social housing, Realist ethnography, New public management.

Introduction

The research sought to identify the real and possible impacts of short-term duration contracts on stakeholders engaged in a sector of the Facilities Management (FM) market place. It focused on the trading relationships between private sector “Suppliers” and public sector “Buyers” providing Repairs and Maintenance (R&M) services to the Social Housing sector. As this channel has specific operational traits and legal obligations that are held in common it provided a controlled opportunity to identify issues that potentially emerge out of short-term contracts.

The Social housing sector of the UK manages in excess of 5.5 million properties, has a rental turnover of £10.bn, and directly employees over 250,000 people. The sector is managed by several thousand organisations, which range from Local Authorities (LA), Registered Social Landlords (RSLs) to Housing Associations (HAs). The sector is highly regulated and controlled, with considerable polarisation in the market place.

The current market potential for R&M Suppliers to the Social housing market sector is in excess of £10.0bn per annum.¹ In the construction sector, this market place is highly sought after, with several of the major construction companies seeking to enter the market due to economic down turn or competitor pressure within their core markets either through aggressive pricing or by acquiring niche market Property services/ FM organisations. The supply chain of main contractors and subcontractors is a major employer in UK Plc – in excess of 65000 FTE’s.

In reviewing the 2011 market position there were a number of trends that were identified, that whilst pertinent to the organisation were also a feature of the Industry. These were; the

¹ An element of the research project was to gather information on a daily basis from the Official Journal of the European Union - TED website regarding government and NGO tenders, their contract term value and the period and specific contract details. Inside Housing published the value of R&M as £14.0bn for 2010.

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Procurement process, and how this influences the structure of the businesses operating within the industry; the Contract, which defines and shapes the business relationships; and additionally the management of the procurement and award process and the management of service delivery.

Our research suggested that short-termism in R&M outsourced contracting does have a potential negative “costs”, for both “Buyer” and “Supplier” expressed as increased *ex ante* and *ex post* transaction costs and that there is a clear link to poor governance within the Value network, which influences operational practice and service delivery, consequently reducing value in use for the residents .

Literature

Today’s purchasing practices are assumed by academics to have evolved in an orderly manner from past practice. Emiliani (2010) suggests “practitioners of modern industrial purchasing and supply chain management lack a historical perspective in the execution of their strategic and day-to-day procurement practices assuming that current practices are favourably grounded in past practice, and as a consequence avoid questioning their own practices in respect of ethics effectiveness or corporate responsibility”. (p116). Further arguing that current practices have ignored history and the hard won lessons and that subsequently procurement practice has become reutilised for both the “Buyer” and the “Supplier” organisations, resulting in tensions between the parties whose interests are fundamentally similar and not different.

Effective procurement process design is limited in practice and outlined specifically by OJEU², but crucially the content and its design rests with the “Buyer” and their engaged

² Directive 2004/18/EC of the European Parliament and of the Council of 31/03/2004 on the coordination of

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advisors. New public management, (Horton, 2003) and the desire to embrace the practices of the “Private sector”, have increased the desire to adopt a price reduction strategy (Oliver, 2006; Arneth et al, 2008), despite what the purchasing media (Supply chain management.com) have long said about the shortcomings of “price beating” and the use of finance based performance based metrics as a measure of success. The Value network for R&M operates within a volatile and highly regulated environment³ with polarisation of “Buyers” and “Suppliers”, and exacerbated by a fixed market in terms of stock volume⁴. The procurement cycle to a point therefore creates the R&M market and frames the context of the relational exchange.

The academic literature available is in the context of the procurement professional. A feature of our research is that the well-intentioned amateur is prevalent in procurement design and process, predominately with a skill bias in finance or operational practice (either housing or maintenance) in all but the largest of the “Buyer” organisations. This links to management practice and capability and again are the consequences unintended or due to unconscious incompetence? Keasey et al (2000) suggest several dysfunctional consequences of such practice specifically misinterpretation, ossification and sub optimisation. Bouwman (1984) compares the decision making process of what are deemed “Experts” and “Novices”, the former who typically transferred reason into recognition, a position supported by Dreyfus and Dreyfus (1986, p30), espousing that “....experts don’t solve problems and don’t make decisions; they do what normally works”. In summary they suggest, finance and operations may not be good surrogates for professionals in purchasing.

However, a lack of economic trust and in particular *ex ante* opportunism, due to poor

procedures for the award of public works contracts, public supply contracts and public service contracts

³ European Union procurement regulations

⁴ Driven by numbers of housing stock and R&M contract duration.

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assessment capability and adverse selection (Rickitts, 2001) cannot be “defended against” by an all-embracing contract. Additionally goal distortion, caused by internal toxic incentives (Chapman, 2005) a “milk and move” culture (Jackall, 1983) and the implications for service delivery when managers “Hit the target” from the perception of securing works for a budget, but “miss the point - fixated on targets without appreciating the impact on quality of service” Bevan and Hood (2006). A point infrequently considered within the sphere of procurement literature is service delivery and *ex post* transaction costs and in particular the cost of measurement and management.

Service quality is created at an operational level, albeit the services delivered have become crucial to the wider strategic, operational and tactical management of business operations. There is an interlinked construct between service encounter and service quality. The service encounter is an interactive process between the “Supplier”, “Buyer” and Resident. However, the context of outsourcing adds additional complexity, which is exacerbated by external audit processes and the requirement to achieve the Standards within the Key Lines of Enquiry. (KLoEs)

Amaratunga and Baldry (2002) outline the traditional perspective of performance measurement and the systems adopted as a means of maintaining and monitoring organisational control; which is the process for ensuring that organisations achieve their aspirational targets or maintain their course on a strategic journey. Parker (2000) cites that traditional business measures have been financial and quantitative, which tend to be insular or inward looking. They are “*lagging indicators*” i.e. considering a “past” perspective or position, and typically fail to include less tangible factors. A business must consider what to measure, as this will force managers to clarify what is important to their organisation. The appropriateness of the adopted measures will be instrumental in communicating progress towards goal or target achievement.

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Brignall and Ballantine (1996) cite evidence from a number of literature sources, specifically management accounting, operations management and strategy, (Kaplan & Norton, 1992) which have highlighted increased forms of dissatisfaction with traditional performance measures, predominately stemming from their failure to monitor and measure multiple dimensions of performance. The measurement of performance has largely failed to adapt to the highly competitive environment in which service businesses operate, where the key to sustainable success and continuous improvement in the design, implementation and the operational delivery of the business proposition is critical to success. Brignall and Ballantine (1996) argue that “Much of the literature surrounding the measurement of performance has ignored the predominance of services and their delivery in today’s advanced economies and the distinctive needs of services when measuring, monitoring and evaluating performance”.(p11) The economies and markets may be advancing, but is this reflected within FM working practice?

Measurement must have an effect on delivery performance, and there is a tendency within the R&M service sector to measure things that are easy to measure, do not reflect the requirements of the various stakeholders and to measure too much. Additionally there are problems relating to implementation, which in turn creates a negative reaction resulting in sensitivity to the metrics adopted and the results reported.

Amaratunga and Baldry (2002) argue that the inappropriateness of measures in FM causes managers and organisations to undertake actions that are incongruent with organisational strategy. Organisations that adopt “good measures” ensure prompt “good actions” and achieve their strategic intent. If FM as an industry sets self-limiting performance measures within the relational exchange, does this impact on the delivery of services and potentially the business proposition of the “Buyers”? Additionally traditional measures ensure traditional outcomes and may have the unintended consequences of achieving the strategic intent of the

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organisation, which may well be sub-optimal i.e. the potential for the organisation is greater than its management perceive – unconscious incompetence?

The generalisation of targets within an industry sector or market place is driven by the perspective of the target set, its link to a specific organisation and how this shapes and defines the organisation through its application. However, from an industry perspective and in particular a market (that is regulated), does the target transcend individual organisations as the market regulation does? What is the scope and impact of target generalisation when considered in the context of commoditised working practices? Tan and Rae (2009) highlight the tension in data collection between what is easy to gather and measure and what is useful to measure but more difficult to gather and focuses on the easy to hit measures rather than the organisationally critical.

Itner and Larcker (1998) suggest that effective targeting relates to basic causality and determining the relative importance of performance measures. Without this triage effect, the unintended consequences of poor targeting practice are distortions in performance. Meyer and Gupta (2004) suggesting that the “day job” becomes the collection of data and monitoring, rather than management activity per se. This has the potential to increase the level of commoditisation of services delivered by an increasing de-professionalised workforce. Here values become less important than the adherence to regulations and rules and finally where a hierarchy of measurement is produced and due to limitations in design, one-measure impacts negatively on another. Humphreys and Francis (2002). Poor target design, (Wankhade, 2011) increases Tunnel vision, ossification and sub optimisation – the pursuit of narrow performance objectives at the expense of organisational objective as a whole. Smith (1995, p286)

The prevalent position for contracted out services is the introduction of a “Service Level

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Agreement” (SLA) within current practice this is deemed to be central to the Supplier / Buyer interface. Kadfors (2008) Normative measurements for the FM services industry centre around *Volume* – typically the “number of activities” e.g. phone calls – made and received, and *Monetary*, being linked to a typical cost, i.e. pounds sterling per M². e.g. cost of painting per M². As part of a procurement process, and linked with a service specification, SLAs are considered an essential element within the contractual governance framework. However, is their design based on a continuum? i.e. the “minimum” level of service required, contrasted with “the best that can be expected”. (Price & Akhlaghi, 1999)

Tranfield and Akhlaghi (1995) argue that such an approach is reactive to the market place as the needs of others or competitive pressures, i.e. external stimuli, such as the use of Schedules of Rates (SOR's), within service delivery and procurement methodologies are setting the agenda. The winners are those organisations that are able to have a control on volume / market share and to influence price, - typically downwards, and so encourage a low cost or price-lead approach and increase further the commoditisation of services. Price and Clark (2009) suggest that FM as a business sector is “... overtly focused on indicators, which are enshrined in various guides, codes and benchmarking schemes” (p6). A possible consequence of this process, taken to its conclusion; is low quality, reduced business performance, increased budgetary pressure and a decrease in overall performance.

Massheder and Finch (1998) undertook research with the UK's top 100 FM service providers. Out of the 25 respondents 14 confirmed that they conducted benchmarking activity as part of their performance measurement programmes. The consensus of the metrics utilised related to traditional quantitative measures that were readily available. The authors concluded that the ease of acquiring and interpreting measured information appeared to be one of the characteristic of FM Benchmarking. Benchmarking can be classified as a means of determining how well an organisation or business unit is performing compared with similar

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units both within the organisation and externally. Parker (2000) cites that use of benchmarking as a performance measure offers a broader perspective, and provides the notion of “*best practice*”; however, it does not indicate levels of performance at an absolute level. Tranfield and Akhlaghi (1995) argue that benchmarking is again a lagging indicator, and as such benchmarking a competitors performance usually results in “performance gaps”, and therefore creates a “*catch up*” situation for operations to address. It is therefore not a strategic option for creating a competitive advantage. Additionally they cite that organisations often benchmark the wrong or inappropriate features of their business. From a public sector perspective this results in a deterioration of performance, as frequently poor content design provides a limiting “glass ceiling” to performance and benchmarking becomes as “race to the middle” proving that you are OK?

There is general agreement in literature regarding the key competitive priorities making up firms’ operational strategies: Cost, quality, flexibility and delivery. Similarly, it could be argued that the effectiveness of organisations’ operations strategy can be measured by assessing the degree of linkage or consistency between the competitive priorities that are emphasised within the business and the corresponding decisions made regarding the elements of their operations. The extent in which operations strategies reflect competitive priorities - from either end of the value system- are translated into operations activities and is a fundamental issue in explaining competitive priorities and performance. The delivery strategy of the “Supplier” and its link to the procurement strategy of the “Buyer” is a critical element of our study, as without congruence the unintended and undesired outcomes are increased *ex post* transaction costs. Buyers have to buy what their requirements are: not what is available. However, does the contract reflect the operational priorities of the stakeholders?

Bowman and Ambrosini, (2000) suggest that there are two forms of value creation. “Use value” based on the specific quality of a service which the “Buyer” experiences in relation to

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a need and the “Exchange value” defined as the financial element of this value i.e. the “price” which the “Buyer” is willing to exchange and the risk that the “Buyer” is prepared to take.

The assessment of value is context dependent based on a “Buyers” perception and is relational and dynamic. The role of perception in assessing value, its dependency of the situation relating to service use, the use purpose and competitive alternatives has been widely researched. (Christopher *et al*, 1991) Ziethaml (1988) proposes that value is subjective and highlights that: costs, benefits and risks are all criteria of “Buyer” expectation of service use. There is a post priori perspective that value is based on experience of the service , a position supported by Gummesson (1998) who suggests that, “...from a customer point of view it could be argued that only when a service has been consumed has it contributed to Value.”(p9) Additionally Dodd (1999) argues that “Buyers” judge value in terms of additional advantage expected or experienced compared to comparative offerings in the case of substitutability.

Value has also been conceptualised as the value of the “Supplier-Relationship” (Lindgreen & Wynstra, 2005) with Rivald and Gronroos (1996) suggesting that it is this relationship and not the service provided that has the major effect on the perception of value, developing trust and making the “Buyer” more tolerant towards occasional inferior performance. Gummesson (1998) promotes the view that “added value” in the context of accounting is synonymous with “cost added”. Productivity, he suggests is associated with lower cost, with a possible consequence of lower quality. The critical element is the incorporation of productivity and quality into a “production- consumption system, where the “Buyer” or consumer of the service is not an end user ... the customer is an agent in an ongoing added value circle” (p9).

Given this position, does the competitive procurement practice in the industry destroy quality and value? Additionally, does the length of the trading relationship further exacerbate that destruction? There is wide spread postulation of the virtuous nature of profit chains – customer relationship life cycles – good external service quality – satisfied customers and

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improved profitability, but there has been little research on the destruction of value and quality through procurement practice.⁵

A major problem that economics associates with the “commons” is that its benefits are readily accessible to all and that it is generally seen to have few barriers to entry and as a consequence is prone to misuse, resulting in the well known “tragedy of the commons”(TOC) (Harding, 1968).

Economic convention presents arguments about the commons, premised on methodological individualism and rational choice presenting a model that conceptualises the commons as being (1) owned by a collective of actors and (2) objectively given, where the pursuit of self-interest can lead to the degradation of the said commons. The basically essentialist model make an assumption that the actors are norm – free and opportunistic maximisers of short-term interests, who in the absence of restrictions to access, their actions tend not to contribute to the long-term interests of the collective. Additionally the collective action of the group has the potential to lead to sub – optimal outcomes for all actors. Consequently, it creates collective misuse and a “degradation” of the commons. Ostrom (1999) describes the “tragedy of the commons” as a metaphor for the problems of overuse, citing that resource users are norm free maximisers of immediate gains, who will not cooperate to overcome the common dilemmas that they face.

The “tragedy of the commons” is frequently cited as an example of market failure, where organisations using the commons impose external costs on their rivals. Mason and Phillips (1997) suggest, “This externality can be both static and dynamic”. The Social housing R&M market is dynamic in terms of competitive procurement practices, which are highly regulated

⁵ Google Scholar, Emerald Business Source Premiere. Search criteria: Competitive procurement practice, destruction of buyer value.

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via OJEU. Al-Fattal (2009), suggests that the TOC has proved to be an important political economic concept as it has the capability to determine cooperation between actors to “conserve the common good and to lessen the transaction costs of negotiation and enforcement”.

Methodology

The design method adopted was one of “mixed methods” via data triangulation or methodological pluralism. The rationale for collecting both quantitative and qualitative data was to allow comparison, validation or corroboration of the results. The two forms of data bring a greater insight into the problem than would be obtained by using only a single type of data. To facilitate this, a convergent parallel mixed methods approach which utilised both quantitative - documentation analysis and, data charting, and qualitative - realist ethnographic via semi structured interviews, a time lapsed study of a RSL SBU and netnography within industry sector blog sites was adopted. “Organisations are often intensely political arenas.....researchers relying on documentary evidence are advised to use triangulation to enhance validity and reliability”, (Saunders *et al*, 2000).

From a design perspective “it is recognised that triangulated or mixed method designs can be fixed or emergent”, (Creswell & Plano Clarke, 2011 p 55), albeit these two positions should be considered as end points on a continuum and not as a clear dichotomy. The triangulation design will be a typology - based approach in which the design emphasises the classification of useful mixed methods designs and the selection and adaptation of that particular design to the study’s purpose, questions and source of data i.e. Mixed method simultaneous design. Morse and Neihaus (2009). Utilising this approach, **concurrent timing** is utilised to implement both the qualitative and quantitative strands during the same phase of the study. Additionally there is equal **priority** of relative weighting. The two strands remain **independent** during analysis and then the results are **mixed** during the overall interpretation

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of the findings.

Sampling

In setting out the method strategy, the overriding goal had to be to see the issue in the “round”, and to identify the rhetoric and the reality of short-termism for all stakeholders. The desired position was to generalise our findings from the qualitative research and that therefore the sample should be a representative sample for the sector / industry being considered. Therefore, a quota sample that would produce a sample that reflects the target population, however unlike a stratified sample, the sampling of the targets was not carried out randomly since the final selection is at the behest of us - the interviewers. To counter this we had a privileged level of access to interview targets within the industry and Value network.

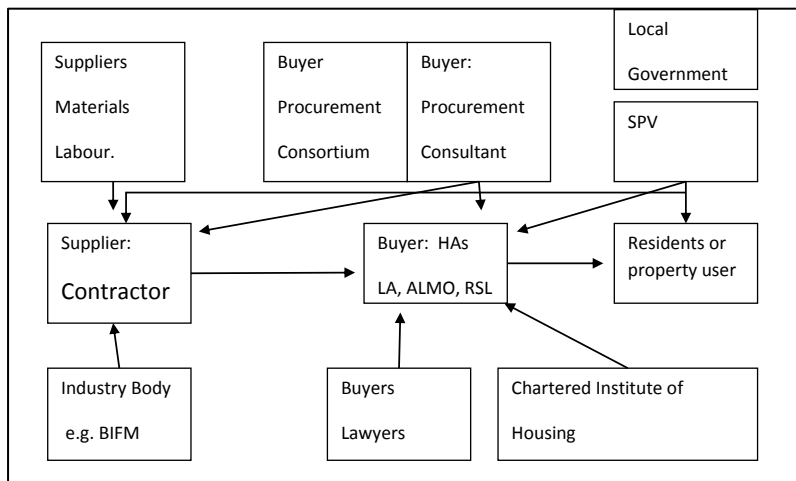


Figure 1.0 The Value network

It could be argued that there is an element of bias due to a non – probabilistic or non- random sampling method being used. However, the source of bias is reduced through strategic sampling via targeted selection and design.

Realist Ethnography

Suckley *et al* (2013) building on the work of Scott-Morgan (1994) suggest that ethnography

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is conceived within current paradigms of organisational studies as qualitative and passive with the ethnographer through immersion in a setting aiming to achieve “a rich interpretation of a particular socially constructed context, hence ethnography has come to be perceived and both inductive and passive”. Their challenge is that ethnography as inductive can be realist and “in this view uncover real unwritten rules of the game in such a manner that enables diagnosis” (Anon 2014). Scott-Morgan (1994) in support for this position argues that analysing ethnographic data for “common motivators”, “enablers” and “triggers” would reveal unwritten rules as routines of organisational behaviour. Additionally suggesting with his pragmatic stance “against necessary immersion” where “...a combination of internal and external research can assist with the speedy elucidation of a particular set of unwritten rules”. Suckley *et al* 2013. (p12). Suckley *et al* and Scott- Morgan seem to be suggesting that ethnography can be any full or partial description of a group as a means of identifying common threads. (p11). The pragmatic approach adopted to the research was broadly ethnographic but is not obeying all the conventions of mainstream ethnography, considering SBU observation, semi structured interviews and netnography within the context of Realist Ethnography.

Documentation Analysis

The emphasis was on reviewing documents that provided an insight into operational capability and performance. In terms of relevance and materiality, the documents were gauged against a rigorous set of criteria. Scott (2004) argues that there are four principle criteria to be considered. These being: *Authenticity*, *Representativeness*, *Meaning* and *Credibility*. The documents to analyse were audited financial accounts and board reports, Audit Commission reports and TSA Surveys: quality control and audit reports, OJEU reports and official “White papers”.

Results

The process for procuring outsourced public sector supply contracts is set out in the EU public procurement directive 2004/18/EC and subsequent directives. Our research focused on the relational exchange between public sector Buyers and private sectors Suppliers delivering R&M services within a Value network and considered the Procurement process, the Contract and the governance of the relationship and Management capability of operational process.

The primary objectives of European procurement legislation are the creation of competition within the supply of services to Government bodies, the delivery of the best value for money by generating the lowest transaction costs to achieve the best procurement outcomes and to aid the fight against corruption. We believe this has generated unintended consequences. It has created interrelatedness within the Value network, adding concentration via “Supplier: Buyer” polarisation and the unintelligent design of process as evidenced by the design content of the OJEU Contract notice. The process has increased in fragility, created contradicting objectives for the various parties and mal distribution within the market.

The research identified that procurement process should be designed to achieve the most competitive price that the services could be delivered for, and to achieve the strategic criteria of the Key Lines of Enquiry (KLoE's) i.e. **“Capacity to deliver”** and **“Value for money”**, via “Exchange Value”. However, in outsourced R&M service supply, “Exchange value” for the Buyer may not equate to “Value in use” for the Resident. With the argument, that the highly competitive nature of the procurement process destroys value creation and service quality. (Gummesson, 1998). The concept of service quality is not understood or is ignored within the design of the procurement process as within this relational exchange a critical element is a “production- consumption” system, which co-creates service quality and develops value in use of the service. (Gummesson, 1998)

As outlined in Methodology, the desired aim was to interact with indicative members of the

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“Buyers” and “Suppliers” within the Value network; to gain an insight into the causes and consequences of short-term trading. The objective was to understand the relationships, boundaries and the constraints in which these organisations operate and trade and additionally to identify its potential impact on the Value network, which has the “Buyer / Supplier” relationship at its centre.

Analysis of EU Evaluation report, Impact and effectiveness of EU public procurement legislation (2011), (EU1) identifies several high level trends, which may be indicative of UK outsourced services procurement but not representative of the Social housing market sector and may challenge the practices of this market. The critical element of procurement process is the design of the published Contract notice. However, the design and content of the Contract notice does not generally consider the impact of service delivery via a Value network and commoditisation of the procurement process created several issues, specifically; mal distribution in terms of contractors and service delivery. i.e. only the larger national contractors could fulfil the award evaluation criteria⁶, consequently sub contracting service delivery to Tier 2 and Tier 3 sub-contractors. The design of the process and the content of the elements of the Contract notice by the Buyers identified a lack of understanding of the process and of the services, which they are seeking to procure. For example, the relevance of buying consortia engaged by the “Buyers” soliciting bids and pricing which was not specific to their housing stock. The relative financial health of the Suppliers and the sub contract delivery of the Value network are not considered. The impact of contract duration and cash flow was not recognised or “surfaced” by the “Buyer; Supplier” interviewees, and was not considered as part of the procurement process selection or evaluation criteria. The critical elements for the Suppliers being contract mobilisation and the absorption of the costs related

⁶ The SME share of contract wins is the lowest in the EU

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to it, and additionally, the invoice settlement terms and its impact on debtor/ creditor days ratios. This is exacerbated by, either increased levels or shortfalls of works against the tendered budget potentially creating further tensions within the Value network. Additionally procurement practice encouraged sub optimal pricing, which created an issue within a Value network delivery system. Pricing of R&M services has been commoditised to assist in the evaluation process, with the frequent use of Schedules of Rates (SOR) or price per property schemes. These impact on the services within the Value network specifically where Tier 2 and Tier 3 contractors are utilised and their cost of operation is unknown by their management. The pricing methodology promotes debate on both the criticality of the procurement process design for “Buyer” and Sellers” and the unintended consequences of their actions. A poor understanding of contract pricing will result in increased costs for the Social Housing sector and create an environment of opportunism for the Suppliers and their multi- tiered supply chain.

Within the Larger HA’s it was frequently identified that the functional procurement team did not know if the contract could be delivered for price submitted by the Supplier , or the impact that accepting sub optimal pricing of the contract would have within the Value network – the content of the Contract notice not considering supply chain delivery. Their sole aim for a successful procurement exercise was to achieve “Exchange value” which was frequently driven by individual incentive schemes.

The rationale for a contract is to specify the rights and obligations of parties within a business relationship and to serve as a communication tool and reduce risk. Within the context of governance, the form of contract should demonstrate a commitment to fulfilling strategic intent and providing structure and management to business operations, but it should not govern how businesses operate. Measurement and governance are mutually interdependent within the contractual requirements of the relational exchange. Johnston and Clark (2001)

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argue that the concept of interlinking is the organisations understanding of the relationships between various measures, and using the knowledge gained, to become “systematically smarter”. A key objective of performance measurement systems and governance systems in which they are embedded is that they should link day-to-day service operations and strategic planning. (Brignall & Ballatine, 1996).

Within the context of mutual interdependency, Hakanson *et al* (2009) propose that the role of contracts and performance measurement systems in value networks is best understood as a variation to the distinction between relationship and hierarchical governance. Specifically within a Value network, there is a requirement for a more complex form of governance / coordination than a hierarchical one, i.e. 1st Tier, 2nd Tier or 3rd Tier contractors, and equipment / materials or services suppliers.

Our research identified that standard forms of contract were predominantly used in the relational exchange due to the “Buyers” familiarity rather than suitability for service delivery. The contracts can be considered incomplete contracts relative to the level of *ex ante* activity within the procurement process, as they did not reflect the heterogeneous nature or the future requirements of the HA and were static relative to the asset and levels of performance over the contract life. The Terms and Conditions (T&C’s) of the contracts had a construction provenance and in conjunction with the performance, measures contained in the contract were not reflective of the nature of the outsourced services, e.g. TUPE.

The Buyers of outsourced services viewed the contract as a defence mechanism against poor delivery and opportunism. Analysis of several forms of standard contracts identified standardised terms and conditions and key performance indicators, (KPI’s) which may not be appropriate or applicable to the services and the HAs asset. There is a clear link to the standard forms of contract utilised in the sector and the concept of Goods-Dominant Logic

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(Enquist *et al*, 2011) with its emphasis on operand resources and physical output, which is driven by the OJEU procurement process and the view that “Exchange value” is the primary requirement for an effective procurement in the “HA world”.

The central consideration for this relational exchange is that it is “outsourced”. Strategically, a fundamental element of the business operations has been seen as non-core to the delivery of their business proposition. The Social housing market place for R&M services is based within a Value network and the difficulties of divergence between “Buyers” and “Supplier” only increase with the introduction of additional parties to the equation (Cardellino and Finch, 2006). The need for regulation of relationships between not only “Buyer” and “Supplier” is seen as critical to multi contractual relationships. All the “Suppliers” confirmed that they subcontracted works, predominately based either on geographical location or on the requirement to supply specialist services. Our research identified that the major suppliers of services may only deliver 85% of their contracted services. The majority of these 2nd Tier and 3rd Tier suppliers are not engaged on back to back contracts with the “Buyers: Suppliers” potentially exposing both parties to financial and regulatory risk which may not have been envisaged by the “Buyers” when the decision to outsource or the procurement process of contractor was designed. Here the main contract is frequently ignored in preference to a construction based standard contract, with whom a Quantity surveyor or Contract manager of the Tier 1 Supplier has an affinity, but which does not reflect the intent of the “Buyers” Contract notice or match the requirements of R&M service delivery.

Performance measurement of service delivery within the Value network is not aligned from a contractual perspective. With both “Buyer” and “Supplier” and their supply chain viewing the “performance” from different perspective within the hierarchies of their respective organisations, as well as between the tiers of sub-contractors causing goal displacement and sequential attention, which may impact future strategic choices for both Buyers and Suppliers.

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The critical questions remain how the performance measures of the Value network should be designed to ensure that they effectively monitor the contracted performance, link to organisational measurement, and do not encourage dysfunctional or opportunistic behaviour. Additionally, how relevant are they to the Value network and the market in which they operate?

All the “Suppliers” interviewed structurally operate on a “Hub and spokes” basis. The dichotomy between the uses of disparate performance measures was clearly exposed by the structure and infrastructure of the business. The issue for all the Suppliers at the “functional / strategic level” related to the targets against which performance is measured, and that the goals and objectives for the SBUs were not congruent. “Supplier 1” and “Supplier 2” used monthly Business Unit Reviews or Cost / Value Reconciles (CVR’s) as a means of measuring Business unit performance against an annual financial “Budget”⁷. Organisational performance is also reviewed at a Contract level and at an “Operational / Regional level”. Here the measurement process can be deemed as “generic operational performance measures” due to the frequency of measurement, and the implied diagnostic power of the process. The Review process is based on traditional contracting review methodology and “Goods-Dominant logic”. (Enquist *et al*, 2011). The central issues discussed within the CVR process relate to the cost of labour and materials. There is a link to the CVR process and to bureaucratic control, and a mechanised model of service delivery. The process cannot be deemed internally supportive (Hayes and Wheelwright, 1994) as there would be a challenge against hitting revenue targets at the expense of other performance targets⁸ e.g. engineer productivity or service quality, which would not enable the organisation to excel

⁷ Those SBUs involved in the delivery of FM R&M services.

⁸ i.e. cash. This is an industry that over trades and provides “credit facilities” for its customers due to the contractual payment terms.

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operationally or financially. Dahlsten *et al*, (2005) suggests that the unintended consequences such a process are fatigue and frustration, which lead to reduced effectiveness and the promotion of local interpretation and variation, primarily due to the measures of performance adopted offering neither qualification nor context. Additionally the use of narrow performance measures does not always identify issues relating to “cause and effect” negatively influencing co ordination and resulting in a lack of corrective action. The identity of the relationships between business performance and operational actions, and operational performance and contractual performance is not routinely recognised within the Value network due to poor design and goal displacement leading to a structural agency (Grey, 2009). This creating inertia rather than improvement, which pervades the Social housing sector leading to a cycle of perennial failure to achieve the desired objectives of the various actors as measured by independent Customer satisfaction surveys. Additionally, the variation in performance measures adopted at hierarchical levels and “board” aggregation creates sequential attention to goals (Katz and Khan 1966). The unintended consequence of this being bureaucratic dysfunctionality is increased *ex post* transaction costs.

The argument by Gummesson (1998), that a drive for increased productivity from an inefficient workforce, under the guise of lowering costs, usually has the unintended consequence of lowering service quality.

Our findings were that the metrics and processes in themselves may be appropriate but the mismatch within the Value network and lack of alignment to contractual service delivery would challenge the principle objectives of a performance measurement regime. The focus of the “aggregated hierarchy of measurements” and variance in measurement methodology within the “Supplier” organisations, is exacerbated throughout the supply network, and could drive bureaucratic dysfunctionality due to goal displacement within the organisations (Merton, 1941). This supports opportunism within the relational exchange due to information

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asymmetry, creating quasi rents and ultimately affecting *ex ante* and *ex post* transaction costs. (Marr, 2007; Hobbs, 1996) A further consideration is the “distance” identified between contractual performance measurement and its relation to measurement used in setting strategic options and decision making for the “Supplier” organisations. Contractual KPI’s are ignored within the management and governance of the Suppliers and their supply chain.

Enquist *et al* (2011), argue that contractual governance and performance measurement are critical to the effective management of business relationships. Analysis of the standard and bespoke contracts in use for R&M delivery identifies the use of KPI’s and the role of customer satisfaction to exercise control over the “Supplier” in the exchange. Traditionally: time, cost and money, are the three primary indicators of performance in construction projects. Meng and Minogue (2011) considered the importance of performance measurement and the effectiveness of models concluding that the use of KPI’s was “Effective” in measuring performance. Conversely, they temper this view by suggesting that “measurement can be ineffective if you do not set the right criteria, and may mislead the performance if the wrong indicators are given.” (Pidd, 2006). The critical element must therefore be the design of the “measures” and they should consider concept, context and content if they are to be effective.

The interviews identified that there was consensus from all parties that “KPI’s had had their day”. However, was this due to poor design and a lack of understanding of what was to be achieved at the point of delivery?

All the “Suppliers” confirmed that the contractual KPI’s are unknown at the time of tender, creating a possible information rent for the “Buyers”. This poses two further questions. If known would, the Suppliers reflect a “degree of KPI achievement difficulty” in the bid price of their tender? Potentially increasing bid costs, or reducing competitiveness and when the contractual requirements were known did this vary their contract mobilisation process? Or is this also standardised?

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There was little connection to the functional strategic measurement process adopted by both the “Buyers” and the “Suppliers”. Similarly, from a “Buyers” perspective, the relevance and consequence of generic operational and detailed performance measures is diminished as performance measurement focus moves from the operation to the strategic levels of the organisation.

These contractual measures deemed as “generic performance measures/ detailed performance measures” support Meyer’s (2002) view of what we want to measure and what we can measure, but do little to improve communication, motivation, control or significantly improvement. Our interviewees suggesting that at the operational level measurement is primarily used to compensate for a lack of “trust”, with a failure against performance measures been seen as confirmation of the lack of trust in the ability of the supplier.

Within the hierarchical structure of the “Suppliers”, analysis of the current theme of contractual KPI’s based measurements have little connection to creating “value” in use for the “Customer to Customer” relationships at the delivery team level. Additionally, the lack of holistic measurement in the Value network indicates, that where providers do not have the same objectives, gaps are created creating the potential for agency and opportunism. The consequence being increased *ex post* transaction costs. (Marr, 2007) The “Buyers” confirmed that they considered the content and format of their contractual KPI’s to be “traditional” for the sector. Baldwin *et al* (2000), arguing that “Buyers” and “Suppliers” select metrics that reflect their expectations, with data that is easy to access⁹. “Buyer” related metrics converging on output, whilst “Supplier” related metrics emphasise the implemented processes. Document analysis identified that the main contract KPI’s consisted of a priority code, a descriptor, and a time frame, or were volume related, either containing a percentage

⁹ Which may be different in reality

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or numeric target linked to a time frame.

Analysis of the KLoEs provides an indication of the process and the measures, which could be adopted,¹⁰ and clearly links a regimented process to the achievement of “excellence” within the audit framework. However, examination of the performance criteria identifies variation in the desired performance outputs, due to poor measurement design and a lack of “client intelligence” to interpret the data and respond with the appropriate actions. (Atkin & Brooks, 2000) The unintended consequence? A potential failure of the performance measure? Alternatively, a satisfied Resident or vice versa? (Bevan & Hood, 2006)

At the point of contractual service delivery, generic and detailed performance measures were utilised. All of which contained KPI's. These again were time bound and volumetric in nature, counting an activity or non-activity, usually against a fixed delivery time. Whilst not as specific as management by objectives, the processes and their measurement were all task focused, reinforcing the bureaucratic functions of the organisation. At the contract level, Meng and Minogue (2011) suggest that performance measurement is a management tool, with performance improvement being the goal? However, if sustained sub-optimal performance is identified, or more importantly not identified does performance measurement provide a call for action for both “Buyers” and “Suppliers”? The critical element must therefore be design. The adoption of KPI's which do not reflect the nature or context of the evolving relational exchange have largely failed to link the contractual performance and organisational performance. In agreement with Price and Clark (2009), the measures adopted must be sector specific or provide a fit to the industry in which they are used.

Additionally, due to procurement practice, mal distribution and the dominance of the larger

¹⁰ Stock Investment and Asset Management: Maintenance works , R&M, Gas, Voids- Value for money

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Supply organisations, the larger firms have a greater scope for conscious planning and economic activity, consequently developing their own mechanisms for control, which, are only secondarily related to market conditions and contractual adherence (Penrose 1959) This assists in creating a concept of sequential attention to contractual objectives, where work is orientated to a linear series of actions which are focused on the internal mechanisms or processes, providing support to the notion of service as a “product” that can be consistently applied and delivered to the Residents. Here the Supplier sets their own performance objectives, which may be contradictory to those of the Buyer, Resident or Contract and can be a form of opportunism.

There is a requirement, within the relational exchange, driven by the KLoEs to provide *Service Quality and Value*. However, due to a lack of clarity and the market’s inability to successfully design, target, collect and interpret subjective data the industry fails to develop the concept that quality is co produced throughout the Value network. Is service quality a real consideration for both the “Buyers” and “Suppliers”? (Yousoff *et al*, 2008) or just the Resident?

The design and structure of the contract should reflect the changing and temporal nature of the relational exchange, and the asset. Either by innovation in design or change order. A position supported within the context of Service – Dominant logic (Lusch *et al*, 2010; Enquist *et al*, 2011). Contract step downs and the use of Tier 2 and Tier 3 sub-contractors highlighted that the “Suppliers did not routinely measure or use proactive measures of assessing the performance of sub-contract delivery. This potentially creates delivery risks for both the “Supplier” and the “Buyer” and is a problem with hierarchical governance structures. Hakenson *et al* (2009). Amaratunga and Baldry (2002) suggest that measures should be appropriate. However, are the metrics used within the contract appropriate for outsourced services delivered within a Value network? Or an effect of further standardisation and

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commoditisation of practice? Critically the OJEU procurement process design and the form of contract did not encompass the use of sub-contract labour by the Suppliers within the Value network, potentially the level of risk to the “Buyer” and Resident are exacerbated.

Dean and Kiu (2002). considered Value networks, in which the public sector and private sector are contracting out services and various activities whilst aiming to control those activities due to them, retaining responsibility to their ultimate customers via contractual means. Enquist *et al* (2011) sought to establish a link between contractual governance and performance measurement within a Value network for public service organisations. They argue that Service-Dominant logic was “essentially customer – orientated and relational, utilising operant resources (knowledge and skill) for the benefit of and in conjunction with another entity as part of an exchange process” (p220) .

There is a requirement for contractual governance within inter - organisational service businesses to have a wider perception of performance measurement, where the measures adopted within the governance framework are considered from an overall stakeholder perspective. Accordingly, flexible to evolving needs of the Buyer, Resident and the business environment and have the capability to develop working practices within a concept of continuous improvement.

The effectiveness of the procurement process and subsequent contract award and governance of the relational exchange can be viewed from the responses of the customer satisfaction survey data and the organisational reviews undertaken by the Tenants Services Authority (TSA) and Audit Commission (AC).

The output of HAs service to its residents was defined in terms of “*Value for money*” as

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defined by the TSA within its 2010 regulatory framework and assessed by the AC¹¹.

Analysis of R&M services delivered at a macro level to the Social housing sector identifies several trends (TSA, Existing Tenants Survey 2008¹²; Housing Corporations Survey of existing Housing Association Tenants, 2006¹³).

The 2006 report cited that ***“There was a clear link between the repairs service provided by the HA and the HA overall satisfaction level”***. With tenants who were satisfied with the repairs service being satisfied with the overall services of the Landlord (91%) and tenants who were dissatisfied with the repairs service reporting that only (28%) were satisfied with the overall performance of the landlord.

All respondents were asked to rate their satisfaction with the way in which their Landlord deals with day-to-day R&M. (71%) were satisfied with this aspect of service delivery. There was an improvement in these figures where tenants had direct experience of the R&M service (75%). However, where tenants had reported a repair but had had no work completed the overall Landlord satisfaction falls to 54%. The Existing Tenants Survey (2008) indicated that 42% of the respondents had had a repair completed in the previous 12 months. Of these 75% of respondents were very satisfied or satisfied with their R&M service. A conclusion of the 2006 report being, ***“...which suggests that between 200,000 and 250,000 tenants had reported a repair across the UK social housing estate and that no repair works had been completed”***.

The key elements relating to satisfaction with the R&M works were:

- the time it took for the works to commence,
- the slow speed with which the work was completed and

¹¹ The Role of the Audit Commission has been redefined following the “bonfire of quangos”

¹² D 19307 successful interviews undertaken by Ipsos Mori

¹³ 9184 successful interviews were conducted with tenants from 97 HAs based in the UK

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- the repair being completed first time.

Drawing on the trends identified in these two surveys and the numbers of properties in the HA estate, it would be reasonable to postulate that there would be approximately 15,000,000 R&M activities per annum and that potentially 3,000,000 of these activities would leave the tenants dissatisfied with the service that they have received. Given the importance of R&M to the tenants in the surveys, and the clarity provided by the KLoEs to the HAs and through them to the supply chain, it could be argued that the procurement process adopted within the Value network and its management does not facilitate a consistent R&M service delivery. Despite the time, effort and cost spent on procurement.

Summary.

Our findings demonstrates that EU procurement regulations, coupled with the traditional working practices within Value network and supported by the standard forms of contract used to regulate and govern the relational exchange introduce excessive costs without creating value in use for the Resident.

R&M service delivery to the Social housing market generally remains product focussed, trade based, and contract managed and driven by Goods-Dominant logic. However, Value network delivery has a requirement for a service focus, skill based, supply chain managed and a Service-Dominant logic. Management at all levels remains task focused with Quality relating to achievement of task, and value created through achievement of a job for a “price”. A lack of comprehension of the issues and stifling of innovation due to bounded rationality has not seen the level of advances in service operations management and contractual governance that have been made in other service industries, primarily as R&M clings to its construction roots and the “Buyers” of services seek comfort and redress within contractual relationships. The static nature of the industry can be observed through is operational structures and practices, which are to a point driven by historically routed strategic competences and poor governance

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design.

The concept of Service quality is not understood or is ignored within the design of the procurement process. Within a relational exchange, a critical element is a “production-consumption” system, which co-creates service quality and develops value in use of the service. (Gummesson, 1998). The findings of the research identified that standard forms of contract were predominantly used in the relational exchange due to the “Buyers” familiarity rather than suitability. They can be considered incomplete relative to the level of *ex ante* activity within the procurement process. The T&C’s had a construction provenance and in conjunction with the performance measures contained in the contract were not reflective of the nature of the outsourced services. The KPI’s contained within the contract are frequently ignored:

- due to volume – the number of “key” items to be considered,
- their relevance to the task - difficulty of obtaining data,
- the prospect of opportunistic behaviour due to information asymmetry, and
- that they are fixed and do not reflect the evolving nature of the asset or the trading relationship.

The contractual KPI’s frequently contradict internal measurement practice, as performance measurement within the Value network is not aligned. With both “Buyer” and “Supplier” and their supply chain viewing the “performance” from different perspectives within the hierarchies of their respective organisations, causing goal displacement and sequential attention. The fixation with “lagging indicators” in the R&M sector, predominately volumetric and time-bound measures is a legacy of the construction sector.

There is a requirement, within the relational exchange, driven by the KLoEs to provide *Service Quality and Value*. However, due to a lack of clarity and the market’s inability to successfully design, target, collect and interpret subjective data the industry fails to develop the concept that quality is co produced throughout the Value network consequently reducing further Value in use for the Residents

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The high levels of TUPE within this market place heavily influence the delivery of services. This is not usually reflected in a standard form of contract, resulting in costly amendments frequently being required to make the contract fit the relational exchange. Critically the contract did not encompass the use of sub-contract labour by the suppliers within the Value network, potentially the level of risk from imperfect commitment to the “Buyer” and Resident were exacerbated.

Ex post costs are a significant feature of the contract management function of the sector, which is driven by the form of contract and the ability of the management cadre to ensure that the desired performance of the outsourced services is achieved. The findings of the research identified that the use of standard forms of contract increased transaction costs, as they were not usually reflective of the requirements of the relational exchange without amendment. The management of performance was impeded due to poor management capability and misaligned goals between the actors. This was further exacerbated by the poor design of performance metrics, which at best misinform or misguide decision making and create the potential for opportunist behaviour, creating quasi-rents for those procuring for the “Buyers”, and the “Suppliers” and their supply chain and increasing transaction costs in the process. Practice challenges current academic writing in this area.

Value is created for the “Buyers” through “Value in exchange” within the procurement process, through potentially securing the supply of R&M services that are fit for purpose for the lowest price. The research identified that that within the TSA and HC Residents satisfaction surveys, 25% of respondents expressed dissatisfaction with the R&M services provided. The management decisions relating to the procurement process and contract management does not routinely create “Value in use” of the services for the Residents. Compound this with frequent contractor rotation, due to contract duration or polarisation and the customer relationship lifecycle is negatively impacted, reducing levels of trust and

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lowering tolerance towards inferior levels of performance on the part of the “Buyer”. This was identified as an area of potential further research.

Limitations

Our research considers a relational exchange between Buyer and Seller for an outsourced service, which is delivered within a Value network. Access to target interviewees did not prove to be problematic and through privileged access, we gained meetings with senior members of the Social housing sector, which assisted our desire to achieve a whole system approach. It could be argued that the organisations were not indicative of all elements of the sector but we are confident that the strategic sample represented the views of the industry. The interviewees were all open, unguarded and refreshingly frank in terms of their response, with only one person declining to have the interview recorded.

Additionally, all the organisations gave us access to internal documents, some of which were deemed restricted, albeit the Freedom of Information Act can still be curtailed through its own process.

We were satisfied with the interview process from two perspectives. Forwarding an outline of the topics for questioning ensured preparedness on the part of the interviewee, most of whom provided us with internal supplementary documentation to develop or support their organisational stance. Additionally we were able to have a mature conversation particularly with the Buyers where there was an interest in the OJEU process per se and an acknowledgement that there was a requirement to improve and develop governance within their outsourced relationships.

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