Smart Procurement for the Long Term

Grant Holland, Senior Consultant, Waugh Infrastructure Management Limited

1. Abstract:

Over the last five years organisations have sought to maximize the benefits gained from procurement. "Smart Procurement" is seen as the key to unlocking greater savings in securing access to products and services.

The delivery of services from Infrastructural asset relies on effective operations and maintenance along with timely renewals and improvements. Much of this work is out-sourced and a variety of procurement methodologies exist.

Appling a business case approach, we will examine if we really are that 'smart' in what we are doing as a sector.

- *What really is value for money?*
- *Are we compromising long term issues as we chase the best value for money option?*
- *Does our behaviour reflect the style of contract we negotiated?*
- *Are our organisations' objectives and our procurement processes aligned?*

This paper is intended to challenge our views of how we procure, and will consider the role and comments of contractors, consultants, local authorities and central government organisations.

2. Introduction

In challenging our views of procurement, it is important to critically evaluate what we, and others do. This paper sites some examples not to criticise their approach but to illustrate the points being raised.

In 2012 the Minister of Transport's Road Maintenance Task Force identified the need for 'smarter buyers'. At that time the contracting industry defined the qualities of a smart buyer as having:

• An improved understanding of costs that better inform their decision making process

• An understanding of the impact delivery models and supplier selection criteria can have on the value of contracts

• Robust forward work programmes that are communicated to the industry and supported by budgets that allows the work to be completed

• Knowledge of the network to determine treatments required based on physical evidence and supported by knowledge of the costs involved

• In house expertise that aids the decision making process and allows acceptance of innovative solutions possibly with or without the involvement of consultants

• A clear understanding of risk and how it is allocated and managed

• An understanding that lowest price will not always deliver desirable outcomes

• An understanding that being prepared to pay more may result in enhanced whole of life value for money.

Moving forward form 2012, the five case model also provides another way to look at the procurement process…

As we seek better results, we should ask if we are we expecting the procurement process to deliver us the result we want; why are we only looking at part of that procurement process?

3. Service Delivery and Procurement -What happens in New Zealand?

All New Zealand Roading Agencies are required to out-source physical works through competitive tendering processes. This has been the situation since the establishment of Transfund in 1996.

The objective of a road maintenance contract is for each class of highway to deliver the desired level of service over the maintenance period for that class – and the desired road condition at the end of the contract for that class – at lowest cost (i.e., the desired highway outcomes for the lowest cost).

Dr Murray Horn and Bruce Gidley, 2013

Over time, there has been a reduction in the number of contracts through aggregation and bundling of works and services and by using longer contract terms. Research commissioned for the Task Force (PricewaterhouseCoopers, 2012) concludes that there is scope for further aggregation and bundling to more effectively and efficiently deliver outcomes. However it is noted that larger contracts do not always deliver better value for money. PWC also acknowledges that there is a risk that further aggregation and bundling may reduce competition and 'hollow out' the structure of the industry. Care needs to be taken to manage the risks to healthy competition in the market. .This 'care' should extend across the sector when the supplier market sustainably and competitiveness is considered:

Given the more homogenous nature of needs of the highways networks, one possibility may be to reduce the number of highways contracts sharply, to under 50 (and perhaps as low as 15–20), as long as at least 150–200 contracts are maintained at the local roading RCA level, to allow a mix of contracts.

The supplier market

Balanced against the desire to establish contract sizes that are both fiscally and economically efficient is the need for competition across suppliers to remains strong. The market must remain able to sustain a sufficient number of willing and able suppliers.

The conclusion from the Task Force was that the markets for both physical works and professional services are currently healthy and that there was scope for further aggregation and bundling to more effectively and efficiently deliver outcomes. The report authors believe that this will not significantly reduce competitive forces in the market, but note that this is a risk.

The New Zealand Contractors' Federation does not agree with this, and in particular took issue with the use of market share and number of tenders received as the primary indicator. The Federation argued that the market would be healthier and better value for money would be achieved if the current trend towards larger and longer-term contracts were to slow.

In acknowledging the risk that further aggregation and bundling may reduce competition and 'hollow out' the structure of the industry the PricewaterhouseCoopers (2012) report notes that:

To ensure healthy competition in the sector is maintained, consideration should be given to the scale of aggregation and bundling, maintaining a desirable mix of contract lengths, and the number of capable tenderers.

NZ Office of the Auditor General, in 2011, identified a similar concern with the supplier market and recommended that "NZTA should also encourage more supplier into maintenance and renewal work, where possible, and the consistency of its consultants and contractors." The report also notes that at that point 'three suppliers was a good mix. The Agency also advised that it recognised that it was a leader and shaper in the of the supply industry.

Moving forward, NZTA identified issues with the NZ Supplier Market through it's 2014 State Highway Procurement Strategy:

"...it is our desire to have four to six prime contractors competing in all parts of the country. This will be a significant change from our current risk of a monopoly consultancy/designer and a duopoloy in the maintenance /contractor market and more closely models our capital works area where we have five prime contractors operating."

Unfortunately the strategic case for this assessment was not broad enough to include other road controlling authorities pity as there is a real interaction between the capability, capability and competition when a wider view is taken.

In October 2014 the Office of the Auditor General published a follow up report to "NZTA: Delivering Maintenance and renewal work on the state highway network. This raises concern about the impact of the approach taken:

We consider that it is important that the New Zealand Transport Agency…ensures that Network Outcomes Contracts deliver the intended financial an customer benefits, without a detrimental effect on the market, by monitoring Network Outcomes Contracts for their effect on market behaviour and pricing and the benefi ts they deliver, and adjusting the procurement process if necessary.

In terms of the Network Outcomes Contract the number of contracts were reduced from 37 to 23 while extending the term to up to nine years, and making one primary supplier for a greater range of services.

4. What really is value for money?’

Defining what value for money means to you is central to smart procurement. Without this understanding, it is very difficult to know what success really is.

In its simplest form Procurement means “The best possible outcome for the total cost of ownership.” While Value for Money is the Core Objective means “The right job at the right time at the right price.” *Around there would there are many recognised definitions of value for money.*

It’s about using money for infrastructure effectively and efficiently.

NZ Office of the Auditor General (2014b)

Value for Money Value for money means using resources effectively, economically, and without waste, with due regard for the total costs and benefits of an arrangement, and its contribution to the outcomes the entity is trying to achieve.

In addition, the principle of value for money when procuring goods or services does not necessarily mean selecting the lowest price but rather the best possible outcome for the total cost of ownership (or whole-of-life cost). Value for money is achieved by selecting the most appropriate procurement method for the risk and value of the procurement, and not necessarily by using a competitive tender.

This definition is as outlined by the Office of The Auditor General in June 2008 published ‘Procurement guidance for public entities - Good practice guide’:

The NZTA State Highway Procurement Strategy 2014 illustrates value for money through the formula shown below.

$$\text{Value for money} = \frac{\text{Functional performance}}{\text{Resources consumed}}$$

The strategy also goes on the describe that “Efficiency and economy have both financial and non-financial attributes, which may include:

- Whole of life
- Economic, social and environmental
- Legalities
- Expenditure of public funds
- Resource limitations
- Supplier market sustainability

5. The Business Case Approach

Knowing your subject

For the sake of simplicity achieving value for money in the delivery of infrastructure based services.

The starting point for a business case is to agree on a problem statement. This could be something like:

> **How can we deliver sustainable road maintenance arrangements that are efficient and effective, while sustaining a mechanism that recognises the objectives of different parties through times of change?**

Establishing Critical Success Factors to Measure Results

What does success look like? Defining critical; success factors, or some measurement framework is essential. These should be aligned with the organisational goals of the stakeholders, and in the case of a transportation business case may be as follows:

- Enhance our physical living environment
- Respond to the desires of the community
- Promote options that assist development
- Afford the lifestyle and standard of living desired
- Access to places and information that allows safe travel
- Sustain the environment that sustains us.

These goals provide direction, and Council has also identified four strategic priorities:

- Investing in community
- Promote integrated, highly liveable communities
- Support areas of economic and district strength
- Ensure critical infrastructure meets future needs

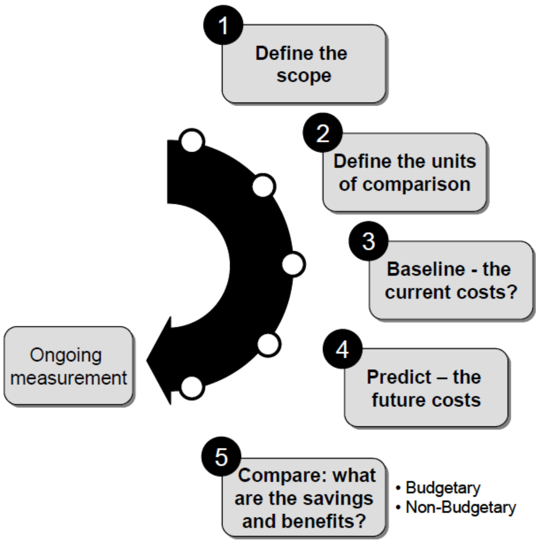
Within the Better Business case suite of tools, there are identified 'Generic' Organisational Objectives; these align well with Council's expectations for this process:

- Improve effectiveness
- Improve efficiency
- Improve Quality
- Meet Statutory, regulatory or organisational requirements
- To reduce costs
- To re-procure services

(Ref BBC: Indicative Case paragraph 31 Organisation)

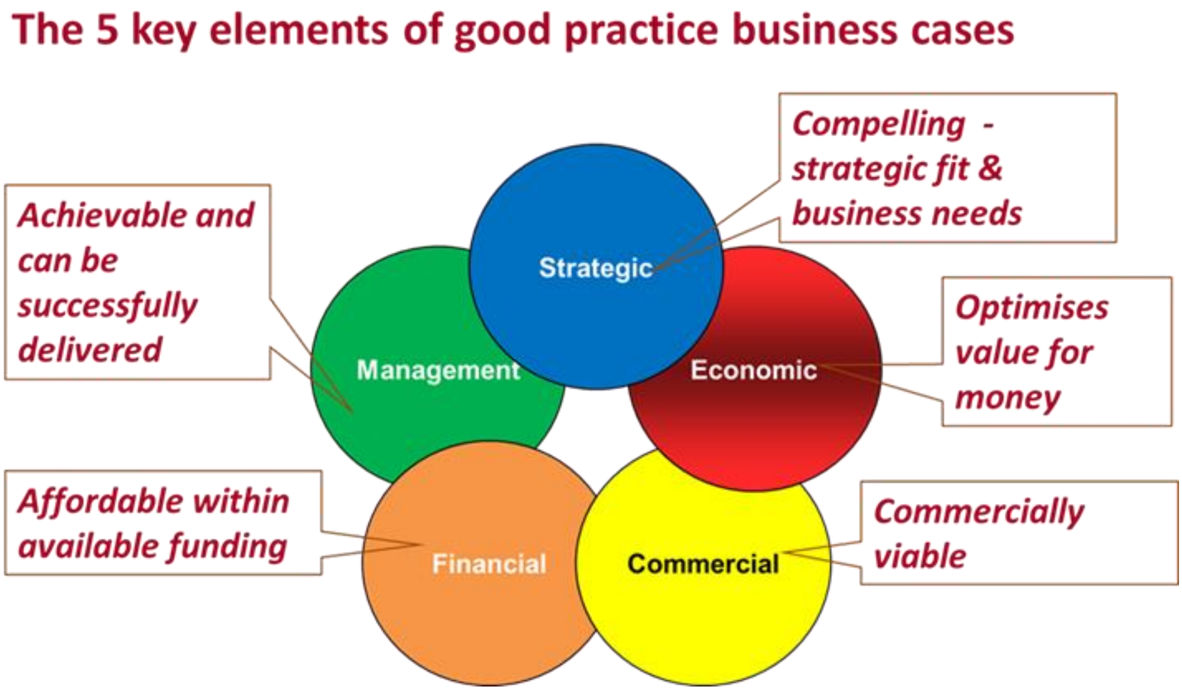
The NZ Government Guide to measuring a procurement savings and benefits notes that "the savings/benefits that result forma procurement activity are generally the result of an improved deal, efficiency improvements or a combination of the two."

In determining if savings or benefits are achieved the criteria needs to be understood. Again the NZ Government Guide to measuring a procurement savings and benefits is helpful.



The Five Case Model

The Five Case Model has roots on the UK Treasury. It now commonly used across the world in assessing options for a range of services.



The five cases are introduced and the application discussed below. The references at the end of the paper provide a selection of opportunities for more detailed discussion.

The Strategic Case

The strategic case makes the case for change and outlines the planning context within which the investment will be developed. It demonstrates that the investment proposal is well aligned to any relevant Government, sector or regional goals and priorities and reflects the organisational strategy. The strategic case should provide a robust and well-evidenced case for change with a clear specification of the investment objectives and required services. The focus should be on service needs driving the investment, not the other way round.

Typically this information will be detailed in the Asset/Activity Management Plan.

Good information about network asset performance helps good decisionmaking about capital expenditure and how to fund that expenditure.

Our own observations and advice from experts is that other countries (such as the United States of America, the United Kingdom, and Canada) have better quality data and collection practices than those that our local authorities use to manage water and roading assets.

NZ Office of the Auditor General (2014b)

Part of the Strategic Case is to ensure the objectives are clearly stated. This is not always the case in New Zealand and the State Highway Procurement Review Issues Report by Dr Murray Horn and Bruce Gidley in 2013.

The problem with the current approach is that the cost of different standards is not transparent and neither is their link to desired highway outcomes. These links are all implicit in the approach, as is the assumption that the cost likely to be associated with the chosen standard is lower than the value road users derive from that standard.

The Economic Case

The economic case is intended to demonstrate that a wide range of options for delivering the required services and meeting the investment objectives have been identified and assessed using best practice economic analysis techniques. The preferred option should provide the optimal mix of potential benefits, costs and risks under varying future scenarios.

The economic case focusses on the costs and how the investment aligns with the objectives. More commonly, value for money is the key attribute.

Transportation services are physically delivered through a suite of contracts. Historically works were undertaken by in-house works crew, but competitively priced tender processes have been required since the 1990's. NZTA's requirements and rules are detailed in the NZTA Procurement Manual. The supplier selection process provides for a limited range of options, but it is assumed that the works must be procured from the commercial contracting sector.

There is a range within the procurement and contracting system for how the service are delivered. Considering and 'testing' these options is an essential part of establishing an effective and efficient approach.

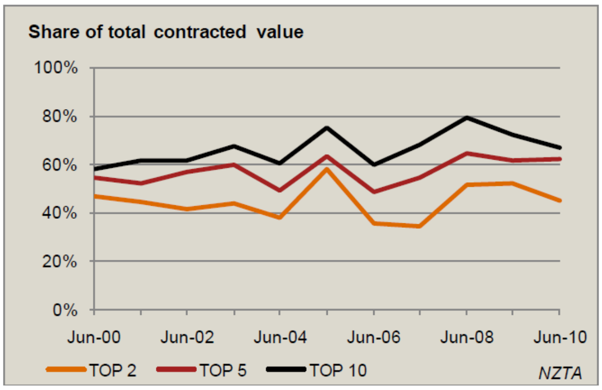
The Commercial Case

The purpose of the commercial case is to show that the preferred option will result in a transparent, accountable and sustainable procurement arrangement that provides value for money over the contract term.

The commercial case focuses on the viability of service delivery from a commercial perspective. Given that the private sector is engaged to undertake the works, the sector must willing and able to perform 'fair work for a fair price'.

The commercial case is often overlooked in organisations long term planning. Frequently there is an assumption that there will be contractors who will do the required works and that the associated price will be acceptable.

The PWC report 'Evaluating different approaches to maintenance and operations procurement (2012) indicates there are less contracts being tendered than in the past and that portions of the market are dominated by large contracting entities.



The Opus State Highway network physical works procurement survey, June 2012 includes a similar observation.

The procurement process, regardless of the selection method is often price oriented. Where tenderers demonstrate similar capabilities for non-price attributes and the price weighting of a tender process is 70% or higher, the lowest price will always win the tender. This is likely to skew the result of the procurement process that the organisation hoped for. It also means that should a contractor wish to secure the work, they have to price to win. It also means that the rates provided (lump sum, unit or dayworks) are unlikely to accurately reflect the actual cost of the work.

If this view is accepted, the procurement process is not an effective method to secure the delivery of maintenance services for an extended period of time, such as five years. If the price awarded for the contract is too low (in order to win it) the successful contractor may not be able to deliver the required works appropriately and either the contractor is unable to make the required profit, or the works are under-delivered.

The tendering process itself is a real cost for both Council and the Tenderers. From Council's perspective there may be a hope that there will be a 'cheap price' tendered and that the costs associated with documentation and procurement will be recovered. However defining the objectives of the work and the methodologies that are acceptable is fundamental and should be regarded as integral to the delivery of services.

From a Contractors perspective, tendering costs are significant. Especially given that submissions will not always be successful and that the costs associated with unsuccessful tenders needs to be absorbed elsewhere.

Considering the Commercial Case is vital if the procurement process (and the outcome) is going to to critically evaluated.

We understand that winning tenders are frequently around 20% lower than the next best price. This is unlikely to be sustainable unless the winning bidders have a structural cost advantage that others learn to replicate, which does not seem to be the explanation.

More likely the gap reflects different ability or willingness of contractors to take risk on short term profitability to stay in what they hope to be a more profitable market longer term. This might make sense if contractors believe they will be able to restore margin after some players find the going too tough and withdraw from the market. If there are also fewer and larger contracts, then they must take more short term risk to stay in the market (see footnote 2 above). If this is what is mostly driving the variability we are seeing, then the market is likely to become less competitive over time.

Dr Murray Horn and Bruce Gidley, 2013

Is this the outcome we seek? We need to look at the process from the perspective of all stakeholders is we are going to be honest with ourselves.

The Financial Case

The financial case shows that the preferred option can be funded and is affordable to the organisation and external funders under various future scenarios. Note that an option may offer value for money, yet not be affordable. The converse may also hold.

The financial case is focussed on the affordability of the delivery of transport services. This relates more to the ability to fund these services.

In New Zealand, Roading Services are funded through rates, fees and charges, and NZTA financial assistance. The NZTA subsidy is derived from fuel excise duty and Road User Charges. These items provide the revenue stream for the National Land transport Fund, which is the hypothecated model used to fund central government's share of transportation. As a hypothecated model, expenditure is limited to the amount of revenue received.

While Local Authorities are keen to limit land rates, they also need to ensure there is sufficient funds through the combination of sources available to deliver an appropriate level of service.

The Management Case

The purpose of the management case is to demonstrate that the preferred option can be delivered successfully using available capability and good practice programme and/or project management processes. This includes setting robust processes in place for project, change, risk and contract management, as well as managing post implementation reviews and realising expected benefits.

The management case focusses on if the proposal is achievable and how services can be successfully delivered.

As discussed under the commercial case, if the procurement methodology is determined by price, this will create tension in the delivery of the contract; especially as the contract term unfolds.

Frequently Contractors and Principals state that the success of the contract is determined by the relationships. Key personal getting the job done, sharing common objectives and mutual respect are enabler of success.

The two factors sitting alongside relationships are financial and quality management. Financial management is central to ensuring the economic and financial cases are achieved successfully. Quality Management is essential to ensuring the delivery of service level is maintained as agreed.

Good decision making will produce good outcomes.

Establishing a contractual arrangement that enables good decision making is the key to achieving value for money. Where the arrangement involves joint decision making between the Principal and the Contractor, effect relationship are vital; where the Contractor is making most of the decisions a quality system is needed to ensure the decisions made are best for the network.

6. Are our organisations' objectives and our procurement processes aligned?

Often the procurement process is regarded as a 'nuts and bolts' issue. While New Zealand Roading Agencies are required to have a Procurement Strategy these are not utilised to their potential. Rarely would they be seen as being part of the suite of key documentation that directs the organisation in the achievement of its goals. A sound Procurement Strategy which takes account of the local procurement environment is essential. This would include discussion on any changes to the level of aggregation and bundling. Alongside this issue, Procurement Strategies are a useful way to ensure customer focus and alignment with organisational goals are retained.

This issues reminds us of the importance of a Strategic Case that reflects the operating environment and issues accurately

7. Are we compromising long term issues as we chase the best value for money option?

The procurement process and supporting systems for the New Zealand Roading sector are well developed and thorough. They are held in regard, and the rates for work are seen as very competitive. However the approach needs o be challenged on a regular basis.

However, there are a number of concerns raised by those with a legitimate value for money perspective that would further improve state highway procurement if they were addressed:

a. Strengthening the confidence of stakeholders by increasing transparency of the options available to NZTA and of the way it sets its priorities and makes decisions.

b. Addressing concerns about the total cost of both maintenance and construction.

c. Increasing the degree to which NZTA added value to New Zealand outside its core business by using its size and expertise to secure more value for the public infrastructure spend nationally and helping ensure that road procurement was consistent with international agreements that aimed at helping NZ and foreign firms compete on an even footing in government procurement internationally.

There are also a number of other areas for improvement that we have identified in the course of this review:

a. Reducing the current degree of separation between construction and maintenance contracts can help reduce whole of life costs;

b. The current procurement portfolio selection model could be usefully refined, with more weight on outcomes; and

c. There are a number of changes NZTA could make that would help support a strong supplier market in the face of what looks to be an unsustainable gap between the winning price and the next best price for design and construct tenders.

While these changes would, taken together, represent a significant change in procurement policy and practice over time, they are essentially an evolution of NZTA's current approach.

State Highway Procurement Review Issues Report Dr Murray Horn CNZM and Bruce Gidley, 2013

8. Does our behaviour reflect the style of contract we negotiated?

Too often when we develop an approach to procurement and service delivery that does align and the 'ducks are in a row' this doesn't play out the way it was intended.

This is a change management issue where all parties need to be involved. A performance based contract needs a different approach to an input based system, and the personal involved need to be the right fit. If you have agreed to a performance based or outcomes contract – the client can't be standing around telling the contractor how to do the job!

9. Concluding Remarks

So what is SMART PROCUREMENT?

UK Department of Defense described it as 'faster, cheaper, better'.

That's a useful definition, but <u>all</u> criteria need to be met to be smart

- Faster – means it's effective, and efficient as the process is dione quicklyy and we to results quicker
- Cheaper – not a term I would support,; does this mean in the short term of the long term? Whjat about 'whole of life considerations? Perhaps value for money is better
- Better – this implieas what we have isnt good enougfh; I would prefer 'fit fore purpose'

So a reworded definition could be:

Efficient and effective, value for money and fit for purpose

1. This is the essence of the economic case.

Adding the rest of the five case model assessment to this definition, the key learnings are:

2. To get the right fit you need to understand the operating environment? This where your AMP and your Procurement Strategy are of much help.
3. Without looking at procurement for the suppliers' perspective how can you set up a successful structure this is viable? Too often this is assumed. All stakeholders need to be considered, for the sort term and the long term,
4. Know what is affordable. This needs to be aligned with the strategic caser. If a match can't be found, it is unlikely a supplier will make it work either!
5. When the rubber hits the road will the asset owner and the supplier achieve what they set out to achieve? There is no point in fooling yourself as supplier of contractor) that you can make it work when you you can't. We need to be honest with ourselves,

When it comes to measuring the success we seek we need to know – is it from the deal or a change in practice? It's important to differentiate between 'budgetary' and 'non-budgetary' savings/benefits. The impact will be different.

10. References

Franks, Stephen 2013, Nobbling the Commerce Commission for cosy capitalism?

Horn, Dr Murray and Gidley, Bruce, 2013, State Highway Procurement Review Issues Report

New Zealand Government, 2010, Guide to measuring procurement savings & benefits

New Zealand Office of the Auditor General, 2008, Procurement guidance for public entities - Good practice guide

New Zealand Office of the Auditor General, 2011, New Zealand Transport Agency: Delivering Maintenance and renewal work on the state highway network

New Zealand Office of the Auditor General, 2014a, New Zealand Transport Agency: Delivering Maintaining and renewing the state highway network – follow up report

New Zealand Office of the Auditor General, 2014b, Water and Roads: Funding and Management Challenges

New Zealand Transport Agency, 2014, NZTA State Highway Procurement Strategy

New Zealand Treasury, 2014, Better Business Cases: Guidance on Using the Five Case Model: An Overview

Opus, 2012, Review of Deliuvery Models for Works and Services

Price Waterhouse Coopers, 2012, Evaluating differenet approaches to maintennece and opertation procurement

Road Maintenance Task Force, 2012, Road Maintenance Task Force 2012 – Review of Road Maintenance Regime

Waugh Infrastructure Management Ltd, 2013, Road Maintenance Contract (Internal) Discussion Paper

Procurement.govt.nz

11. Appendix: Delivery Models in New Zealand

The following delivery model selection matrix is taken from the Task Force-commissioned report *Review of delivery models for works and services* (Opus, 2012).

Selection Criteria	Day Works	Traditional	Hybrid	PSMC/ PBC	Alliance
Scale	<$1m	<$15m	<$15m	>$15m	>$15m
Network Size & Shape	<100km	<500km	>500km	>500km	>500km
	Accessible	Accessible	Accessible	Accessible	Accessible
Network Complexity	Simple	Moderate	Moderate	Complex	Complex
	Very basic data	Good data available	Good data available	Excellent data available	Good data available
	Rural	Rural/urban	Rural/urban	Rural/urban	Rural/urban
Supplier Market Conditions	Excellent	Very good	Good	Limited suppliers	Limited suppliers
Level of Client Involvement	High	Medium	Medium	Low	High
Flexibility to Deal with Change	High	High	Medium	Low	High
Innovation Potential	Low	Medium	Medium	High	High
Transfer of Client Risk	Low	Medium	Medium	High	High
Stakeholder and Customer Requirements	Low	Medium	Medium	Medium	High
Focus on Non-cost Areas	Low	Medium	Medium	Low	High

Grant Holland, Senior Consultant, Waugh Infrastructure Management Ltd

Grant Holland is an Asset Management specialist with a wide variety of experience in Local Government AM and Engineering. This includes surveying and land development, asset management system development, and infrastructure planning and management.

Grant holds a degree in Surveying and a Post Graduate Certificate in Executive Management and is Qualified Tender Evaluator.

Grant has been a Senior Consultant with Waugh Infrastructure Management for over ten years, working throughout New Zealand. He worked for Southland District Council for the seven years prior to that during which he was Chair of the NZ Hansen User Group.

PHOTO