

GETTING THE BEST FROM THE LOCAL GOVERNMENT CONTRACT PROCUREMENT PROCESS - A CONTRACTOR'S VIEW

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ABSTRACT

In a world experiencing increasing financial pressures, including the global economic climate and the costs of long-term infrastructure development and maintenance, asset owners – including local authorities - are continually looking for ways to reduce operational costs. Under legislation, local authorities are also required to prove best value and face challenges in demonstrating this in a way other than purely by price.

These pressures have resulted in outsourcing the delivery of contract activities and turning to different methods of contract procurement, often with varying degrees of success.

The procurement decision process can be fraught with challenges in terms of how the contract service delivery is procured. This process can significantly influence and drive contractor behaviour, not only in the way tender prices are developed but also in the development and management of systems that will be put in place for the life of the contract.

Other critical decisions such as the form of contract, e.g. lump sum, schedule of rates or measure and value, can also significantly impact on the risk profile associated with the development of tender prices and service delivery behaviours.

This paper outlines a contractor's view on the entire contract procurement process. It aims to provide an insight to asset owners on the processes and systems that contractors believe will deliver them the best outcome for their service delivery needs. It also aims to ensure the right behaviours are put in place from day one of the contract procurement process to improve the success and efficiency contract model.

KEYWORDS

- Procurement
- Tender
- Asset Owner
- Contractor
- Lowest Cost Conforming
- Weighted Attributes
- Basis of payment
- Risk Profile

1 INTRODUCTION

Asset owners should always aim to achieve value for money whenever they procure contracting industry services. This requires clear project definition and selection of the best procurement method for the project. Procurement is the phrase given to the process by which asset owners achieve the delivery of their construction projects.

There are a number of factors that affect the procurement decision that must be considered when establishing the desired procurement and evaluation model. These include the nature of the project, time constraints, cost certainty requirements, the complexity of the project, regulatory and market forces, and the risk management strategy

The procurement decision has a significant effect on the outcome of the construction process and relies upon a clear understanding of each party's drivers, open and positive relationships, an appropriate contract form and evaluation and selection process.

The supplier selection process is the means of obtaining the preferred supplier to deliver the outputs based upon best value for money principles. Procurement evaluation is the method in which tenders submitted for construction projects are assessed against set criteria.

The procurement evaluation must carefully consider each tender on an equal basis against the evaluation criteria and ensure that the best tenderer has the capacity and capability to meet the requirements of the contract.

Asset owners, or procurement agents working on behalf of asset owners, must ensure that the procurement and evaluation methodology balance the risk trade off between expertise and price to deliver the overall best value for money.

The level of risk associated with developing the contract price has a significant effect on both parties. New models being established have attempted to investigate the alignment of drivers between the two parties, with pain/ gain models, management of cost fluctuations, incentive schemes and penalty clauses. All of these have varying challenges in ensuring both parties manage and share the risk appropriately.

Aligning the evaluation decision to the project outcomes and procurement objectives is critical to the success of the project in place.

2 UNDERSTANDING THE RESULTS OF THE PROCUREMENT PROCESS

2.1 Background

Best value, as defined by Douglas D Gransberg, Professor, University of Oklahoma, is "a procurement process where price and other key factors are considered in the evaluation and selection process to enhance the long-term performance and value of construction." This is demonstrated by reducing life cycle costs, time savings, innovations, enhanced quality or improved risk management

Construction projects can be broken down into two forms

- Projects that require expertise – highly complex, time constrained and variable cost
- Projects that require resources – standard model, minimal time constraints, higher certainty of cost, low complexity

There are a number of recognised tender evaluation methods, as outlined in the New Zealand Transport Agency Procurement manual with the most common three used being:

- Lowest Cost Conforming Price – the contract is awarded to the lowest cost price that conforms to the tender requirements
- Weighted Attributes – the contract awarded to the contractor who has the highest overall attribute score against weighted criteria. The criteria includes price evaluation
- Quality based – The contract is awarded to the contractor with the lowest price after taking into account deductions for 'valued' quality innovations

It is important to acknowledge that asset owners and contractors have different drivers of performance:

- Asset owners' drivers – the critical drivers of performance for local authorities, as asset owners, include: asset condition, value for money, financial certainty, high levels of customer service and appropriate risk management
- Contractors' drivers – the critical drivers of performance for contractors include: the ability to deliver a long-term profitable return on invested funds, reputation in the market, contract retention and ensuring staff stability as much as possible

When deciding on the appropriate evaluation methodology asset owners in New Zealand need to take into account the Statements of Good Practice on procurement that were developed by the Office of the Controller and Auditor-General in 2001. These are outlined as follows:

- **Total cost of ownership** – when assessing a procurement proposal, a public entity should be aware of the whole of life cost of the goods or services it procures
- **Value for Money** – this does not necessarily mean selecting the lowest price. Care should be taken to ensure that unreasonable delivery risk is not assumed in pursuit of the lowest whole of life cost.

Asset owners need to understand the possible effects of their procurement decisions on the supplier base as decisions can reduce or destroy competition.

Careful consideration must also be taken with regards to the drivers of both the designers and builders which the asset owners are engaging and ensure that appropriate behaviours in terms of tender pricing and contract delivery match the desired outcomes of the project.

Advantages to the owner of securing the right procurement and evaluation model include best value pricing for the life of the assets, risk sharing, committed contractors and a successful project outcome.

Disadvantages to the owner of choosing the wrong procurement method or contract form would result in the misalignment between the project outcomes, procurement and evaluation and contract specification. If misalignment occurs, no matter which procurement or evaluation methodology is chosen, it is likely to result in a less than optimal project in terms of delivering best value.

2.1.1 DESIRED OUTCOMES FROM THE PROCUREMENT PROCESS

As procurement outcomes are critical to the success of the project, serious consideration needs to be given to the following outcome factors prior to completing the procurement process:

- There needs to be a clear understanding of the projects objectives, i.e. understanding why the project is being constructed and how will it be used
- Understanding the design and construct complexity and scale – a small contract will require a low skill set as opposed to significant contracts which will require multiple resources and skills
- Knowing the time requirements of the project – timing of the project is critical when determining the desired skills of a contractor. Urgency of the project will need to be considered as part of the evaluation of the designer/ contractor
- Understanding the capability of the market – research needs to be undertaken as to whether there will be tenderers available for the project with the required skill sets
- Being aware of budget constraints – consideration needs to be given as to whether there are any issues with securing the required budget as this could result in significant changes to the scope to the contract after award. This can also result in significant variations being required to the contract which could be costly and disruptive to both the asset owner and end user
- Researching the attributes of the organisation that will be engaged to carry out the design and construction – being aware of the staff skill sets, resource capability, and technical and management experience are the various parties
- Understanding the values of the organisation that will be engaged to carry out the contract – does the contractor have the same ethics and values as the asset owner? A miss-match in this area could cause significant problems in terms of a clash of cultures and values.
- Deciding upon the required KPI's to be delivered on during the contract - consideration needs to be given as to the key deliverables during the term of the contract.
- Knowing how the procurement process will be able to lower project costs and drive efficiencies in the delivery of the project
- Assessing how the risk can be reduced or shared as part of the procurement process? - removing risk from the supplier could lead to a reduced price, as the risk factor does not need to be incorporated in the contract price

- Understanding what are the political, environmental and social requirements are - these need to be clearly understood as these issues may influence the project completion
- Consideration given to any other factors deemed important to the asset owner in order that they can select of the most suitable contractor

2.1.2 PROCUREMENT METHODS

There are many recognised forms of procurement that are utilised in the market, however the two that form the majority of procurement processes are the Request for Tender (RFT) and the Request for Proposal (RFP). Both have significant differences in terms of the response and evaluation process.

To get to this stage of a procurement process, asset owners can select from a Request for Interest (RFI) process, a RFP process or an open tender process.

An RFT process is a very formal process that requires the contractor to conform to the letter of the tender requirements. It is a process which revolves around the contracting industry providing the asset owner a price for precisely what the asset owner required, with supporting documentation to prove the contractor has the technical capability and resources to meet the technical specification of the contract. A RFT process works well in projects that require resources as outlined in section 2.1 above.

An RFP process, whilst still a formal tender process, allows the contractor to be more innovative and outline what they believe to be the best possible approach for meeting the needs of the asset owner. The contractor must assess all facets of the service delivery requirements and deliver the best overall value to the asset owner. The RFP puts the emphasis on the contractor to clearly explain what they are going to deliver to the asset owner for the price submitted. A RFP process works well in projects that require expertise as outlined in section 2.1 above.

It is hard to assess which of the two procurement methods is more effective. The decision is best made based on the level of certainty the asset owner has over the outcome of the project. If there is high certainty, both in terms of specification and output, then a more formal Request for Tender process is preferred. If there is uncertainty over the project or contract outcome, and the asset owner is looking for the expertise of the contracting industry to assist, then a Request for Proposal method may be best suited.

2.1.3 EVALUATION METHODS

There are a number of recognised tender evaluation methods utilised in the New Zealand contracting industry, with each having different effects on contractors. Asset owners must carefully consider their procurement objectives and align them with the evaluation method utilised to ensure that the project or contract has every chance to succeed.

The three most common evaluation methods are:

- **Lowest Cost Conforming** – where contractors are predominantly evaluated on price alone, the lowest cost conforming evaluation method can be advantageous to both the asset owner and contractor as it indicates a clear process for winning a tender. However it can be disadvantageous to both parties in terms of the overall process if there are no clear outcomes and goals as contractors may try to reduce quality, both in short and long-term performance to lower the overall price and increase the chance of winning the procurement process.
- **Weighted Attributes** – where contractors are evaluated against set criteria including non-price attributes the weighted attribute evaluation method can be advantageous as it allows the contractor the ability to prove their value in aspects other than price. However it can be disadvantageous as despite the quality attributes offered, as contractor may be unsuccessful against a substantially unsustainable lower price.
- **Quality Based** – this form of evaluation method may be best where contractors can offer innovation and quality that is assessed to determine the preferred contractor before a price is

negotiated. This is advantageous as it allows the contractor to offer the most innovative solution to deliver best value in terms of the overall project. However it can be disadvantageous in terms of the difficulty in ensuring that innovations will actually be valued by the asset owner and agreement over the overall best value.

It is vital that the asset owner does not let the process get in the way of the decision they want to make. Many processes are undertaken when the defined process provides a result that the asset owner may not be happy with. This could be as a result of the weightings used in the evaluation methodology or the contract form that is chosen which may benefit one contractor over another.

When developing your tender documents, asset owners should allow themselves the scope to work with the submitted tenders to gain the best result possible for the project or contract outcomes. This can be as simple as adding a clause that says "Before the tender is awarded, the principle reserves the right to negotiate with any of the submitted tenderers."

In addition to price, all forms of tender require an attribute submission. When compiling the attribute submission to support the tender price, contractors are asked to follow a prescribed method in terms of compiling information and details. This is often extremely detailed and requires considerable time to prepare.

Whilst it is understandable that the tender evaluation team do not want to read through volumes of text in the responses received and consider a page limit for the responses, asset owners need to be cognisant of what they are asking for in terms of volume when setting a page limit. If there is a five page limit, then the questions must reflect this in order to allow contractors significant room to compile their responses in the manner required.

2.1.4 BASIS OF PAYMENT DECISION

As with tender evaluation methods, there are a number of recognised contract forms in terms of the basis of payment. The four most common are early contractor involvement; lump sum (fixed price); schedule of unit rates (measure and value); and cost plus.

This, like many others in the procurement process, is a very important decision as it has a significant bearing on the allocation of risk associated with the tendered price. The more certainty contractors have, the less risk is built into the price. Contractors are predominantly risk adverse and will price risk accordingly into the tender price.

Whilst asset owners may have a preference over the appropriate form of prices in the contract, these reasons may have the opposite effect in terms of achieving the overall best value of the contract due to being incorrectly matched to outcomes or be incorrectly balanced in terms of sharing the risks associated with the project or contract.

An analysis of the most common forms of the basis of payment are as follows:

- **Early contractor involvement** – a contract in which the contractor is engaged during the specification and design stage of a project or contract. The contractor is selected to the status of preferred contractor based on a selection process based on attributes alone, who then works collaboratively with the asset owner to build the contract or project specification, design and target price.

The collaborative team decides on the appropriate basis for payment, risk allocation and risk management process and work methodologies for the project or contract prior to the establishment of the target price.

This model is an emerging contract form in the New Zealand industry and has significant advantages where it is difficult to allocate risk appropriately at tender stage and therefore difficult to establish an accurate project or contract price. It also engages those that will ultimately build the project or deliver the contract at the development phase to ensure an optimal service delivery model can be established.

Within New Zealand procurement procedures, asset owners must ensure their process selects the appropriate contractor, prior to the price being submitted to pass the test of proving best value from the procurement process.

- **Lump Sum** (fixed price) – a lump sum contract provides the asset owner with a fixed price for a defined piece of work. The fixed price includes the recovery of overheads and profit required from the project or maintenance contract. This method is common in short term construction projects and in maintenance projects where there is a predominance of planned and programmed works such as a parks and grounds maintenance contract.

When pricing a lump sum contract, the contractor relies on the completeness and accuracy of the specification of service delivery requirements. If there is any ambiguity or potential for risk throughout the life of the contract, the contractor will adjust their price accordingly.

In terms of a project or maintenance contract, the lump sum approach provides the asset owner with greater budget certainty, which may be a greater driver than the lowest overall price for the contract. However, asset owners must realise that by adopting the lump sum approach, it negates the ability to gain actual cost information in terms of asset maintenance and actual levels of work completed, which is critical to long-term asset management planning and delivery.

- **Schedule of Rates** (measure and value) – the contract price is made up of a list of unit rates multiplied by an estimated number of quantities for each scheduled item. Each rate includes an allocation of overhead recovery and profit. This method is common in a reactive maintenance contract where it is difficult to accurately define the scope of services required within the contract period – for example in water and wastewater reactive maintenance contracts.

Once again, when pricing a schedule of rates, the contractor relies on the clarity of each rate in terms of its relation to the technical specification and output requirements such as KPI performance requirements. If aspects of the rates cause ambiguity, the contractor adjusts the price accordingly.

Within a schedule of rates, the asset owner inherits the quantity risk, as they pay for the actual work provided, and the contractor inherits productivity risk as they are required to deliver each rate within defined pricing submitted at tender stage. Because of this, the asset owner has less budget certainty than for a lump sum environment and must work proactively with the contractor to work within overall budget constraints. Despite the lower budget certainty, the asset owner will achieve better clarity in terms of asset maintenance costs (from an 'averages' point of view at least) and gain a better understanding of the work that is actually completed. This knowledge can be utilised in long-term asset management planning and delivery. A disadvantage of the schedule of rates approach is that it does not provide any ability to share in the productivity savings achieved.

- **Cost Plus** (day rates) – a cost plus contract is made up of a schedule of rates for labour and plant that are paid on an "as used" basis. Material and subcontractors' costs are paid at cost plus an agreed margin. This method is common in contracts where it is virtually impossible to define the scope or technical requirements of the contract.

As there is little risk on the contractor in terms of rates or productivity as most often they can provide lower rates for labour and plant resources. Each hour of work completed is charged to the asset owner with the agreed margin for profit and overhead recovery.

This contract form requires little in terms of technical scope and specification and tender stage. The risk in terms of the quantity and total contract price is inherited by the asset owner so must work proactively within the contract to work within financial constraints. Once again, the budget certainty is lowered from an asset owners point of view, but will be able to provide extremely accurate costing information in terms of asset maintenance history.

Despite the move away from this type of contract, managed carefully it may very well provide the lowest overall cost to the asset owner for the service delivery requirements.

Cost fluctuations – contracts are being released that do not provide for cost fluctuation adjustments over the term of the contract. This is an attempt to stop the contract increasing in price over its term.

It is a common misunderstanding that cost fluctuations are merely an increase in price and therefore profit to the contractor, in reality they are a reflection of the actual cost increases incurred for the services provided.

If cost fluctuations are not allowed for throughout the term of the contract, the contractor will increase the year one price to allow for the expected increase in the last year of the contract. Therefore the asset owner will pay in excess of the annual cost fluctuations in advance of when they occur. If the contractor is unable to accurately predict the cost fluctuations in advance, then it will simply err on the side of caution and increase the estimated increase.

By excluding cost fluctuation adjustments, asset owners are more likely to pay extra than if the cost fluctuations were included in the contract.

The contract bond – There has been an introduction of large contract bond requirements included in projects and contracts. These bonds appear to far outweigh the cost implications of a contract default. A contract bond comes at a significant cost to the contractor, both in terms of the actual cost of the bond and the tying up capital that is not able to be used for other development.

There would have to be a significant breach in terms of contract delivery for a bond to be actually actioned by the security holder. This may also come at a cost to the asset owner to action the bond. Therefore the cost and ability to use the bond restricts its effectiveness and may not benefit anyone in the contract relationship.

What may be more beneficial is a more detailed KPI performance framework with minimum performance requirements that links to the term of the contract. This may have more positive effects on the contractor's performance than the performance bond.

2.1.5 GETTING THE LINK BETWEEN THE CONTRACT FORM (SCHEDULE OF PRICES) AND THE TECHNICAL SPECIFICATION RIGHT

Over the past decade, there has been a shift from an input-based specification contract to an outcome-based contract with high levels of performance requirements. This has been a very positive move in the contracting market and has set clear expectations on the contractors' performance requirements.

However, one of the issues of an outcome-based contract that asset owners continue to write input-based specifications within outcome based contracts.

When compiling a tender price, the contractor looks for the accurate and defined linkage between the schedule of prices and the specification requirements of the contract. Whilst it is the asset owners' responsibility to clearly outline the technical requirements, a clearly defined output specification is all that is required when working under an outcome-based contract.

In an outcome-based contract, it is the contractor's requirement to develop and deliver internal processes and procedures that will meet the contract outcome requirements. These are no longer the responsibility of the asset owner. The asset owner must spend more time accurately specifying the outcome requirements and leave the method statements and quality assurance procedures to the contractor.

There is a real drive towards looking for new and innovative models in which to manage contracts going forward. These include aspects of measuring actual versus tendered costs, real-time reporting and ongoing efficiency and productivity gains.

These new contract models put significant requirements on both the internal structures of asset owners and contractors in the industry. Therefore it is vital that these are carefully considered in terms of their capability to deliver. Existing structures that have been put in place to support historical contract models may not be appropriate to support new contract performance models.

2.1.6 PICKING THE RIGHT KPI STRUCTURE

When choosing an output specification contract, it is imperative that there is a clear linkage between the contract goals and the KPI structure.

It is unrealistic to be dissatisfied with a contractor who is meeting the defined KPI targets. All too often the situation arises where the asset owners are unhappy with the contractor's performance despite the contractor meeting the KPI performance measures.

When considering the KPI framework that will drive the performance of the contractor, asset owners must ensure that this aligns to the drivers of the contract. Asset owners must align their agreed LTCCP's, asset management and activity management plans with the day to day operational performance requirements of the contract. If there is a miss-match between what is needed and promised to the end user and what is required from a day to day contract delivery perspective, dissatisfaction is likely occur.

2.1.7 PROBLEMS THAT ARISE FROM THE WRONG PROCUREMENT METHOD

Contractual issues can arise when one or both parties have a difference of opinion on what is required within the contract. This is usually overcome through the successful negotiation and clear joint understanding of the contractual requirements and project outcomes. Nearly all contracts in place require some form of negotiation; the tender evaluation method often determines when that is going to happen.

In a Lowest Cost Conforming tender process, the contract is awarded to the lowest price submission. There is normally no negotiation period as part of the selection process. Negotiation in this type of contract comes in the form of variation requests that occur through the life of the contract that must be negotiated as they arise. This can be highly disruptive and expensive if the contract documentation is not clear from the commencement of the contract.

On the other end of the spectrum in a Quality based process, negotiation can be undertaken at the commencement of the contract in a collaborative and positive manner, which paves the way for a contract with little disruption and movement to the overall project price.

Whilst the tender evaluation method has an effect on contractors' behaviour during the tender submission process, the method in which the asset owner manages the contractual relationship has the most significant effect on the behaviour during the service delivery stage. Asset owners must ensure that they manage the contract in alignment with the way they procured the services.

3 CONCLUSION

It is imperative to understand that the proposed procurement method will have differing effects on the components of a project or contract. Whilst certain procurement methods may work well for asset owners providing financial and risk benefits in the short-term, it is recognised that these same methods and decisions can drive certain behaviours in the contract that may not align to the long-term goals of the asset owner.

Careful consideration must be given to the project or contract outcomes, the procurement method and the contract requirements in order to ensure that the appropriate procurement method is utilised.

Advantages to the owner of securing the right procurement and evaluation model include best value pricing for the life of the assets, risk sharing, committed contractors and a successful project outcome.

Disadvantages to the owner of choosing the wrong procurement method or contract form would result in the misalignment between the project outcomes, procurement and evaluation and contract specification. If misalignment occurs, no matter which procurement or evaluation methodology is chosen, it is likely to result in a less than optimal project in terms of delivering best value.

In terms of the tender evaluation methodology:

- Lowest Cost Conforming is best suited for short-term, low skill, low value projects with concisely detailed contract specification and outputs and tight budgets

- Weighted Attributes should be used when budget constraints are of significant importance but where technical expertise and attributes are still a relevant requirement to ensure successful contract delivery
- Quality Based should be used where it is difficult to clearly define and manage the risk associated with project delivery, both in terms of short-term design and construction costs, time and risks and the total life cycle costs

In terms of choosing the appropriate basis of payments

- Early Contractor Involvement works well when the risks are unable to be quantified at the time of tender which makes it extremely difficult to establish an accurate tender price
- Lump Sum may give you budget certainty, but increases the risk to the contractor and therefore may not achieve the best value for the project
- The Schedule of Rates approach shares the quantity risk but must carefully define what is and what isn't included in each rate
- The Cost Plus approach provides little risk to the contractor, and therefore can achieve the best overall pricing and works well in a target price/ budget cap environment.

Whichever method is chosen in order to get to the commencement of the contract, the asset owners responsibility is to consistently manage the contract within the parameters of the contract. The contractor is not at fault if there are contractual ambiguities. The asset owner has every right to enforce the contract to what has been agreed upon, however they cannot enforce changes without negotiation and often compensation to the contractor due to there being a mistake or omission at the tender stage.

The goal of an asset owner is to procure services with contractors who commit to a high performance culture and commit to working in a collaborative environment to lift the level of project delivery and reduce whole of life costs.

It is up to the asset owners to carefully align their outcomes with the procurement process, evaluation criteria and contract specification to procure services in a way that will ultimately meet these needs and maximise the best value from the project.

The most important decision is to find the best balance of risk between the asset owner and contractor. Asset owners cannot contract out risk and expect not to pay for it. When the correct balance is found, the best overall value will be delivered to all parties.

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