Obtaining Value for Money on Service and Operational Contracts

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Prior to establishing Business + Risk Solutions, Kym was General Manager of SA and WA for an international engineering and environmental firm. Kym also held senior management roles in Local Government across two councils in Adelaide, where he managed a range of commercial and governance portfolios.

**Areas of focus**
- Commercial Training
- Strategic and Project Commercial Advice
- Corporate Governance
- Leadership and Team Development
- Alliancing and Relationship Contracting
Session Focus

- Contracting as a relationship
- Procurement Planning
- Key Stages
- Key Contract Clauses
- Summary
Contracting is just another relationship

- Effective relationships are not one way. They are mutually beneficial.
- Can you imagine approaching a friendship, employee or marriage in the way we sometimes approach our service providers?
The two keys to an effective relationship

1. Tell others what you think, feel and want
2. Ask others what they think, feel and want

Most contracting is focussed on suppressing the other party - MASTER SERVANT.
It becomes a two way process of supressing the other party to protect ourselves, but in doing so we both pay a price.
Constructive approach to contracting

We can deliver great outcomes and mutually benefit

MASTER
I win you lose.

Costs:
- Energy spent by both sides protecting one-self rather than outcomes.
- Short term relationship – high cost of re-tendering and contract administration.
- Excessive internal processes in place to manage ‘perceived’ risk.

SERVANT – My needs are sub-servant to yours.

Costs:
- Focused on keeping people happy, not delivering outcomes.
- Focus on following processes and rules, not delivering outcomes.
- Slow to make decisions.
- Don’t speak the kind truth. Leave landmines for another day or project.
## Benefits of a Win/Win Approach

<table>
<thead>
<tr>
<th>Service Providers</th>
<th>Organisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greater profit certainty.</td>
<td>Greater value for money.</td>
</tr>
<tr>
<td>Reduced contracting costs.</td>
<td>Reduced contracting costs.</td>
</tr>
<tr>
<td>Reduced risk and certainty.</td>
<td>Reduced risk.</td>
</tr>
<tr>
<td>Repeat work and long term opportunities.</td>
<td>Achievement of outcomes for stakeholders and value for money.</td>
</tr>
</tbody>
</table>
## Costs of a Win/Lose Approach

<table>
<thead>
<tr>
<th>Direct Costs</th>
<th>Hidden Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal Disputes + Contract Disputes.</td>
<td>Contract Administration – Adversarial nature costs in time, money, energy and responsiveness.</td>
</tr>
<tr>
<td>Tender Costs – Consultants, Probit etc.</td>
<td>Opportunity Costs – What could we be doing with time, money energy etc.</td>
</tr>
<tr>
<td>Quality of Work – Defects, Rework, Preventable landmines</td>
<td>Time to market and responsiveness – Delays in initiating works, getting works completed, responding quickly to issues</td>
</tr>
<tr>
<td>Contractors pricing in hidden margins and over-recoveries within contract price.</td>
<td>Internal Labour Costs – Often overlooked</td>
</tr>
<tr>
<td>Contracts pricing in contingency and risk within contract price.</td>
<td>Cost creep on contract supervision – Internal labour growth</td>
</tr>
</tbody>
</table>
Cost Sensitive vs. Budget Sensitive

Cost sensitive is focusing on lowest price, but ignores quality, innovation, risk.
Budget sensitive is focusing on keeping cost within budget, but ignores risk and cost.

Value for Money
Focusing on getting the right outcome for the right price.
Balancing quality, innovation, risk and reward depending on nature of service.

*Horses for courses approach.* Sometimes about lowest price, other times about innovation or quality or risk mitigation.
# Procurement Planning

<table>
<thead>
<tr>
<th>Method</th>
<th>When</th>
</tr>
</thead>
<tbody>
<tr>
<td>FIXED</td>
<td>Scope, responsibilities, risk allocation, and cost allocation is clear, and there is a competitive market for these services.</td>
</tr>
<tr>
<td>Lump Sum</td>
<td></td>
</tr>
<tr>
<td>Fixed Price</td>
<td></td>
</tr>
<tr>
<td>Design &amp; Construct</td>
<td></td>
</tr>
<tr>
<td>VARIABLE</td>
<td>Scope is unclear. I.e. feasibility work, consulting reviews, etc.</td>
</tr>
<tr>
<td>Schedule of Rates</td>
<td></td>
</tr>
<tr>
<td>Time + Materials</td>
<td>Service is low value, low risk. I.e. painting, administration etc.</td>
</tr>
<tr>
<td>OUTCOME BASED</td>
<td>Service is complex, and council does not have skills to supervise contractor. Pay on performance of outcomes which are measurable.</td>
</tr>
<tr>
<td>Performance orientated contract</td>
<td></td>
</tr>
<tr>
<td>Pain / Gain</td>
<td>Service has high value to community. I.e. waste, major infrastructure, health (i.e. nursing home, hygiene) etc.</td>
</tr>
<tr>
<td>Bonus or Retention</td>
<td></td>
</tr>
</tbody>
</table>
Fixed Price Arrangements

Fixed price arrangement contracts have their place when we know exactly what we want.

Contractors are generally skilled at managing their commercial risk. They do this by:

- **Qualifiers, assumptions and disclaimers** – i.e. making certain things exclusive from the fixed price.
- **Scope creep + variations** – charging variations for changes in scope, even minor.
- **Rise + Fall** – building rise and fall adjustments into contractors for highly volatile costs such as fuel, labour, imports etc.
Recognising Transaction Costs

There is a cost of buying stuff.

There are ways of meeting probity and open competition requirements without high costs of procurement.

These include:

- Appropriately designed procurement framework which is pragmatic in risk profile of goods and services that balances risk and reward.
- Panels.
- Collaborative purchasing
- Procurement planning. Matching right procurement method to nature of purchase.
Key Stages

- Procurement planning - choosing the procurement method
- Risk and Cost Allocation Table
- Defining Key Result Areas and Key Performance Indicators
- Defining Evaluation Criteria
- Designing Contract Pricing Approach, Tender Forms + Conditions of Contract
- Commercial Alignment
Key Stages - Creating the right expectation from the start

Scope Development
Condition of Contract and RFT
Commercial Alignment

80%

Designing the right commercial conditions from the start into the contract

Good conditions that lead to transparency
Designing Contracts for Optimal Performance

**Incentivising contractor behaviours** – Aligning commercial incentives with achieving contract outcomes.

**Allocation of risk** – Ensure best party manages the risk to reduce total (internal + external) cost of managing contract.

**Alignment of contract price with service providers cost structure** – reduces inefficiency, over-recovery of overheads, and super margins.
Commercial Alignment

- Workshop with shortlisted tenderers.
- Commercial alignment is part of achieving the win/ win outcome for both parties.
- It builds rapport, trust and respect by dealing with commercial issues upfront.
- Clear expectations upfront. Builds constructive relationship and reduces contract disputes. Openness and transparency drive the process.
- Ensures both parties are ‘eyes’ open regarding contracting terms.
- Transparency and openness.
- Appropriate risk allocation.
- Focus on what it is important to client. Outcomes, Key Result Areas and Key Performance Indicators.
- Understand what is important to contractor (i.e. profit, cost recovery, cash flow, risk)
Incentivising Contractor’s behaviour

Alignment of mutual interests- Win/ win approach

What does organisation want?

Outcomes

↓

Key Result Areas

↓

Key Performance Indicators

↓

Commercial Incentives

What do service providers want?

Mutual interest

Profits

Remuneration
Risks through Experience

Risk Allocations- Balancing Risk & Reward

Are you getting the balance right between risk and reward?

Is risk aversion driven by personal risk or organisational risk?

Does the commercial model match the desired outcomes and key risks?

Who can best manage the risk – you or the contractor?
Risk Allocation Table

- Assist the consultant in being clear about responsibilities
- Ensures the contractor doesn’t build any contingency into the price or at least minimises this occurring
- Ensures expectations are clear

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Example for a Waste Management Contract

<table>
<thead>
<tr>
<th>Item</th>
<th>Council</th>
<th>Contractor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vehicles, Plant and Equipment - Acquisition</td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>Vehicles, Plant and Equipment - Maintenance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vehicles, Plant and Equipment - Depreciation and Amortization</td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>Labour+ On Costs</td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>Vehicles, Plant and Equipment - Fuel+ Oil</td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>Insurance requirements</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Public liability</td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>- Vehicles Plant and Equipment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Workers Compensation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Manage Complaints and Enquiries</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>Customer Satisfaction Surveys</td>
<td>x</td>
<td></td>
</tr>
</tbody>
</table>
Contract Price - Getting Value for Money

Commercial Efficiency & VFM

- Recognise contractors need to make a profit
- Link contract price and variations to contractors cost structure
  - Reduces risk + contingency for contractor
  - Removes hidden margins for council
- Openness and transparency

<table>
<thead>
<tr>
<th>Contract price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable Costs</td>
</tr>
<tr>
<td>Fixed Costs</td>
</tr>
<tr>
<td>Profit</td>
</tr>
</tbody>
</table>
## Labour Driven Contract

<table>
<thead>
<tr>
<th>Labour Multiplier</th>
<th>Raw Labour Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Rate</td>
<td>Salary On Costs</td>
</tr>
<tr>
<td>Multiplier =</td>
<td></td>
</tr>
<tr>
<td>Raw Labour Rate</td>
<td></td>
</tr>
<tr>
<td>Between 2.0 and 3.0</td>
<td>Between 5 and 15 %</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Labour Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed Costs</td>
</tr>
<tr>
<td>Profit</td>
</tr>
</tbody>
</table>

- Other Variable Costs (Re-emburseables)
- Materials (paint, cable etc.)
- Sub Contractors
- Travel

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**Business + Risk Solutions**

*Results through Experience*
Labour Driven Contract

- Contractor recovers fixed costs and makes profit through staff’s time charged on job.
- Overheads on variations and overtime. Already recovered in standard hours, therefore represent ‘hidden’ margins. Therefore should be no overhead.
- Margins on materials, sub contractors, travel etc. Already recovered overheads and profit in labour multiplier. Therefore should be no margin.
- Profit margin – within 5 to 15 %
- Overall labour multiplier – between 2.0 and 3.0
- Salary on cost rates be lower on casuals and contractors.
- Overheads should be lower for long term, and full time arrangements – lower non productive time.
Common Qualifiers and Assumptions

- Areas excluded due to lack of definition e.g. consultation on projects
- Silent on different charge out rates (Employees, Contractors, Casual)
- One off project costs
- Number of meetings, Number of site inspections etc.
- Variation clauses
- Lack of accountability on locking in key personnel you are engaging
- “Market” increases to salaries, fuel
- Mark-ups on disbursements, project costs etc.
Equipment Driven Contract (i.e. waste)

<table>
<thead>
<tr>
<th>Multiplier</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operator Costs</td>
</tr>
<tr>
<td>Depreciation</td>
</tr>
<tr>
<td>Fuel + Oil</td>
</tr>
<tr>
<td>Wear Items</td>
</tr>
<tr>
<td>Maintenance</td>
</tr>
<tr>
<td>Fixed Costs</td>
</tr>
<tr>
<td>Profit</td>
</tr>
<tr>
<td>Other Variable Costs (Re-emburseables)</td>
</tr>
<tr>
<td>Raw Labour Rate</td>
</tr>
<tr>
<td>Salary On Costs</td>
</tr>
<tr>
<td>(Purchase price – WDV) / Operational useful life</td>
</tr>
<tr>
<td>Rise + Fall implications</td>
</tr>
<tr>
<td>GET, Tyres</td>
</tr>
<tr>
<td>Corporate Overhead (100 % of all firms non direct labour costs)</td>
</tr>
<tr>
<td>Dump fees, processing fees</td>
</tr>
</tbody>
</table>
Equipment Driven Contract

- Depreciation is a key area contractors hide profits. Either by using accounting useful life instead of operational useful life, applying escalation rates to depreciation, not incorporating the re-sale value of machine etc.
- Fuel is subject to rise fall. High area of risk for contractor due to volatility.
- Depreciation and overheads on variations and overtime. Already recovered in standard hours, therefore represent ‘hidden’ margins. Therefore should be no overhead.
- Overheads include site supervisors.
Some key contract clauses

- **Key Personnel** - Ensure that the team you are seeing from consultants are the ones that are going to do the work.

- **Approved Personnel** - Ensure the consultant will only charge for people that have been approved by client.

- **Project Reporting on monthly basis** - Ensures that there is transparency over the projects performance and that Client are kept informed at all times

- **Sub-contractors** - If it is necessary to use sub-contractors, the consultants needs clients’ prior written approval – no hidden mark-ups.
Some key contract clauses

- **Direct Project Expenses** - All direct project expenses passed through at cost with no margins and multipliers.

- **Good Faith** - Obligation on the parties to co-operate in achieving the contractual objectives and a duty to act honestly.

- **Insurances** - At a level that the Contractor can justify that there is acceptable residual risk remaining with the Client.

- **Force Majeure** – Manages risk in an event beyond Council control.

- **Right to audit** – Ability to audit contractors books and ensure transparency.
Summary

- A two way relationship based upon openness and transparency
- The key is to deliver a win/win arrangement for both the organisation and the service providers
- Focus is on the risks, outcomes and results you are looking to achieve
- Requires good planning up front
- Strong alignment will increase the probability of success on your projects
- Need to ensure you design it in to your contracts up front rather than implement after the event
Questions

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