

Service Competition Guidelines

NSW Government

1997

The development of this document was oversighted by the Service Competition Project Advisory Committee of the Council on the Cost of Government. The development was assisted by advice received from many NSW Government agencies and from the Labor Council and public sector unions.

These guidelines replace the *Competitive Tendering and Contracting Out Guidelines*, the *Competitive Tendering and Contracting Out Costing Guidelines*, and the *Contracting and Market Testing Policy* produced by the Premier's Department in 1991, 1992 and 1993 respectively.

Copies of this document can be obtained from the Government Information Service, telephone (02) 9743 7200. Section 1, 'Executive Briefing', can be read on the internet home page of the Council on the Cost of Government (internet address <http://www.occg.nsw.gov.au>).

New South Wales. Service Competition Policy Advisory Committee

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1 Executive Briefing

First and foremost, the onus is on managers to drive performance.

Managers, from the chief executive officer downwards, should routinely pursue performance improvement. Managers should routinely provide for:

- active pursuit of the best value for money in the performance of activities and the delivery of services;
- monitoring of quality, costs and processes of activities against standards and benchmarks reflecting the best known practice;
- information on performance, including the provision of accounting information of greater relevance to determining costs than standard budgetary data; and
- in-depth reviews of all activities every two to three years, as warranted.

Attention to information on performance is particularly important. For example, without reliable and complete information on the costs of an activity, cost comparisons are meaningless.

The objective of service competition policy is to provide a means to drive performance through harnessing competition.

Service competition is the use of competitive forces, indirectly or directly, to achieve the best value for money.

- Through indirect competition, by way of comparing in-house performance with the best known performance achieved elsewhere, in-house groups are encouraged to achieve equivalent levels of performance or better.
- Through direct competition, by way of competitive tendering following consideration of all relevant factors, the work is allocated to the tenderer offering the best value for money.

Where tendering is to occur, in-house providers should be given the opportunity to compete on equal terms with external tenderers. In-house groups are to be assisted to improve performance for this purpose and assisted to develop a tender.

Competitive tendering should only be considered after in-house improvement has been fully explored.

Initially, in-house improvement or, where appropriate, joint arrangements between agencies for common services, should be pursued. The use of competitive tendering may then be considered for areas where substantial benefits can be realised only by that means. Pursuit of the best value for money may be achieved by a range of means including:

- cessation of activities which are no longer needed;
- re-engineered in-house options;
- joint arrangements between agencies for common services;
- services provided by the private sector; and
- mixed systems of internal and external contractors.

So that the focus will be on realising substantial benefits, sensible threshold levels and appropriate criteria are to be applied in identifying activities for competitive tendering.

As a general rule, unless there are sound reasons to do otherwise, consideration of activities for competitive tendering under this policy should focus on areas where:

- the normal annual cost of the activity, or combination of activities, exceeds \$250,000, subject to other relevant factors, such as risks and other constraints; and
- where in-house cost levels are estimated as higher than 8-12% of viable, alternative service providers, based on the best available information.

Inter-agency opportunities are to be pursued.

Managers should be alert to opportunities to achieve efficiencies through amalgamating activities across agencies and letting one contract to a government or non-government provider to supply a service to a number of agencies. In this way, substantial benefits which could not be achieved on an agency-by-agency basis, may be realised.

There are a number of essential elements to service competition.

There are a number of essential elements which must be taken into account when implementing service competition, including those set out below.

- Staff and unions are to be consulted early in the process.
- Performance standards are to be developed.

- Cost data are to be properly identified and collected.
- Social justice values such as equity and access to services are to be protected.
- Probity and competitive neutrality are to be ensured.
- The responsibilities and accountabilities of all parties must be explicit.

There are potential pitfalls at all stages, so careful planning and implementation are essential.

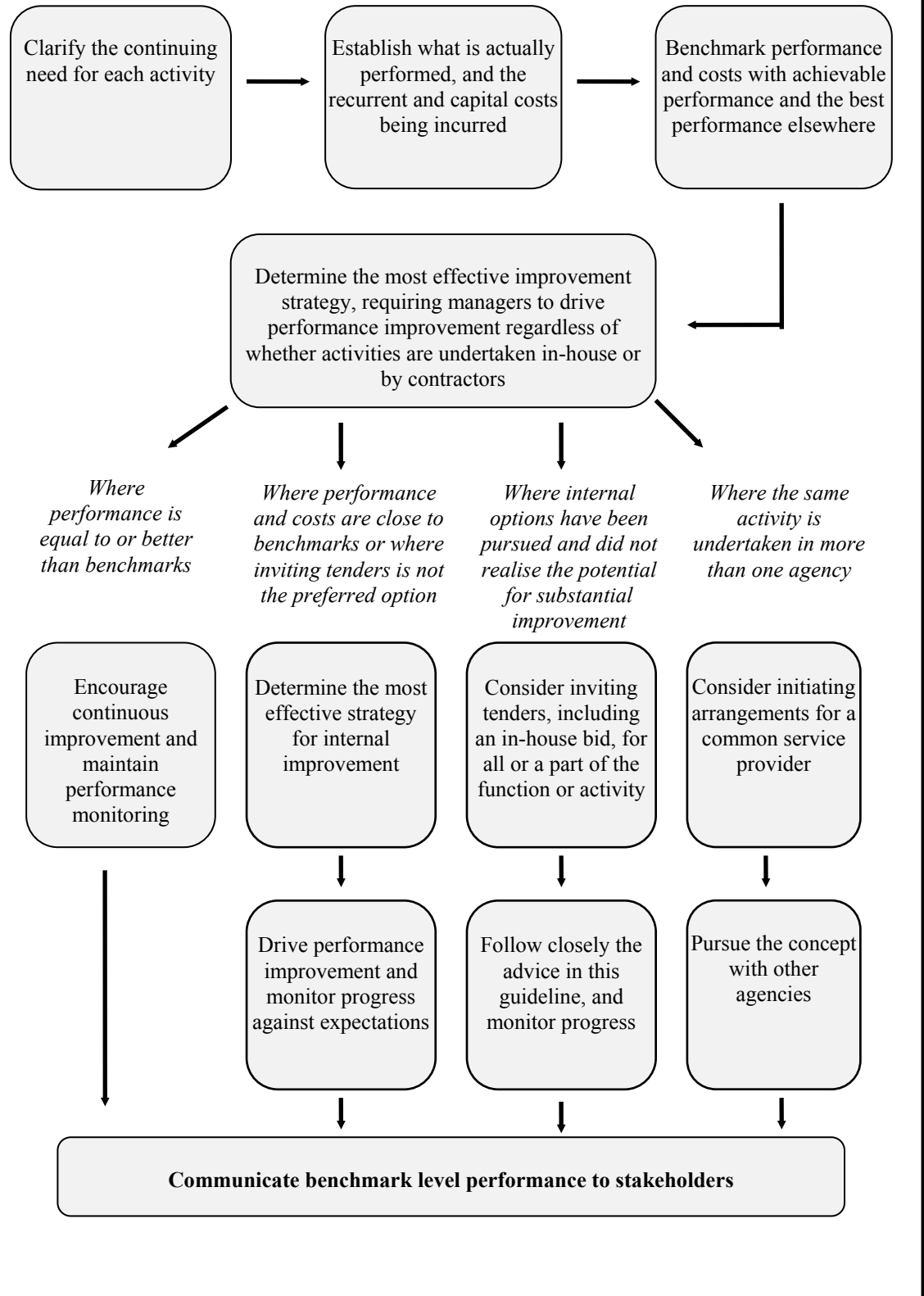
This document is a guide for agencies in implementing the NSW Government's service competition policy. Section 2 further elaborates the policy and sets out the principles to be applied. Section 3 focuses on competitive tendering which is the area requiring detailed guidance. The guidance should be supplemented by other sources, as appropriate to the issues being addressed.

Progress will be monitored.

The emphasis of monitoring by central agencies will be on substantial developments both on an agency-by-agency basis and on a cross-agency basis. Surveys and implementation reviews will be undertaken.

Box 1 Management action chart

The essence of service competition policy is the pursuit and realisation of the best value for money in the performance of government activities. This will require managers to:



2 NSW service competition policy

2.1 The policy and the principles

The primary objective of service competition is to achieve best value for money in the performance of government activities and the provision of services.

1995 Financial Statement

The Government's initial approach to service competition was outlined in the *Treasurer's Financial Statement* of June 1995¹.

- All Government agencies are to incorporate market testing and contracting reviews as part of their formal business planning.
- Progress will be monitored through an annual survey and select post implementation audits will be undertaken both to check that policy is being followed and to keep the appropriateness of policy under ongoing review.
- In-house providers will be given every opportunity to compete on equal terms with external contractors.
- The Office of the Council on the Cost of Government will act as a research and information provider to assist agencies in planning their market testing and contracting initiatives.

Those requirements and provisions remain central to the policy, with two qualifications.

- In implementing the policy, the pursuit of best value for money, rather than the adoption of a particular means of achieving that end, is the essential factor. The most appropriate means can only be determined after case-by-case assessments.
- Market testing under this policy means testing in-house performance against what the market place can offer, but this does not necessarily mean seeking competitive tenders. The option of inviting tenders should only be considered where efforts to improve in-house performance have not realised clear potential for substantial benefits.

Where appropriate, agencies should seek ministerial approval for their preferred means of achieving best value for money.

¹ NSW Treasury (1995), *Treasurer's Financial Statement*, page 51.

The principles

Box 2 sets out principles for planning and implementing service competition policy. The principles require, for example, rigorous appraisal of options; effective monitoring of performance and costs; and the protection of the interests of service recipients, the Government, and its employees. The actions of agencies must be consistent with these principles at any point in the processes.

Box 2 Service Competition Principles

- ***We will routinely pursue the best value for money.*** All managers, from chief executive officers to supervisors, will routinely pursue the best value for money in the performance of activities. Value for money includes concern for quality, reliability, and initial and ongoing costs. Value for money is not necessarily provided by the lowest cost.
- ***We will monitor performance and costs against standards and targets.*** Whether an activity is performed in-house or by an external contractor, performance and costs will be monitored against standards and targets and, if practicable, against external benchmarks.
- ***We will rigorously appraise various performance improvement options.*** Managers will identify and pursue opportunities to achieve the best value for money, focusing initially on in-house improvement. Inviting tenders for the performance of an activity will only be considered where in-house initiatives have not realised the potential for substantial benefits. Opportunities for joint service arrangements with other agencies will be identified and will be pursued where warranted.
- ***We will not consider alternative service delivery arrangements if that compromises the best interests of Government.*** Some functions of government need to be maintained in-house for legislative, strategic or commercial reasons.
- ***We will ensure that social justice is taken into account in decisions.*** The Government is committed to enhancing social justice goals of equity, participation, access and rights. This commitment will be built into processes and contracts where appropriate. It is expected that contracts will require compliance with anti-discrimination legislation.
- ***We will encourage innovation.*** Agencies will seek out innovative practices whenever that is likely to provide benefits in terms of service delivery or value for money.
- ***We will consult with staff and unions and keep them informed of developments.*** Genuine consultation will occur and include opportunities for employees to raise their concerns and have them addressed, while maintaining the commitment to the realisation of the best value for money.
- ***We will protect the interests of employees.*** Policies will be sensitive to the needs of employees. Where tenders are called for, in-house bids will be encouraged where practical. Preference will be given to bids which, in best satisfying value for money requirements, include offers of employment to include existing staff. Assistance will be given to any staff made excess.
- ***We will ensure fair and effective competition and uphold the principles of competitive neutrality.*** Probity will be ensured and competitive markets will be promoted. Agencies will not obtain an inappropriate advantage by virtue of Government ownership.
- ***We will ensure that the parties with responsibilities are accountable for meeting those responsibilities.*** This will require setting clear service standards and monitoring providers against those standards. Private contractors will be legally bound to meet agreed responsibilities. However, whether the activity is performed in-house or by an external contractor, the Government must remain accountable for the delivery of a service and its costs.
- ***We will subject activities to service competition on a periodic basis.*** All government activities will, as a matter of course, be subject to review to ensure they continue to meet service standards and value for money objectives. Reviews will be undertaken towards the end of contracts or, for in-house activities, at agreed intervals.

The principles in box 2 underline the point that the application of service competition policy in New South Wales is not driven by any alleged desirability of replacing public sector with private sector service providers, or of maintaining in-house provision in lieu of better alternatives.

**Focus for
tendering**

So that priority is given to cases offering substantial benefits, consideration of inviting competitive tenders for activities now undertaken in-house should focus on areas and combinations of areas where:

- the cost of the activity exceeds \$250,000 p.a., calculated on avoidable costs², and subject to other relevant factors, such as risks and other constraints; and
- where in-house cost levels are estimated as higher than 8-12% of viable, alternative service providers, based on the best available information³.

The thresholds are not intended to restrict the discretion of agencies to determine how best to allocate their resources including when to engage contractors. It is appreciated that agencies often engage contractors to perform tasks of monetary value well below \$250,000 p.a., and for reasons other than cost.

**Concern for
employees**

The Government understands that performance improvement initiatives can be disruptive and threatening to employees and is particularly concerned that employees be treated fairly and equitably. Fair and equitable treatment of employees includes:

- provision of timely and accurate information;
- opportunities for employees to raise their concerns and have them addressed;
- assistance to employees to improve the efficiency of in-house operations; and,
- where appropriate, assistance in the development of an in-house bid.

At the time of publication, employment issues arising from these guidelines were under consideration by a working party established between the Premier's Department and the Labor Council of NSW and public sector unions. Specific provisions dealing with employment issues will be published separately. If, at the time of implementing these guidelines, an agency is in doubt as to those provisions, immediate advice should be sought from the Public Sector Management Office of the Premier's Department.

The benefits from service competition can be expected to vary widely, depending on the pre-existing levels of efficiency, performance levels in comparable organisations, the intensity of competition, and factors specific to the case in point.

² Refer to appendix C for the method of calculating avoidable costs.

³ Estimates of cost differences at the time of this decision will inevitably be approximations. It is unlikely that the cost of external provision would be known with any precision without a firm specification and a full appreciation on the part of an external provider of the risks and other factors likely to impact on costs.

Estimates of savings

Indications of the savings achievable through competitive forces have been obtained through annual surveys of contracting conducted by the NSW Government since 1993-94. One aim of these surveys has been to establish the average level of savings resulting from contracting. The findings have been that the average is in the vicinity of 17 to 20%⁴. This is slightly higher than the findings from other research, which suggests that the average savings vary greatly between activities, ranging downwards from between 9 and 14% of costs⁵. The savings estimates are problematic as they are based on unaudited cost data collected in surveys and there are uncertainties as to the extent all relevant costs are accounted for, such as: how overheads are apportioned; how contract monitoring costs are estimated; and how costs are linked to quality and output measures.

The debate over the size of average savings possible through the tendering and contracting option should not detract agencies from exploring all available mechanisms for improving the efficiency and effectiveness of activities and services.

Probity issues

If competitive tendering is undertaken, probity must be ensured. Tendering processes can be exploited corruptly as a consequence of loose processes and controls. Where there has been no improper conduct, unsuccessful bidders may perceive bias and/or corruption as a consequence of lack of confidence in the integrity of the process. This is a particular risk where the successful tender is an in-house bid.

Section 3 provides general advice on a number of key probity issues. More specifically, agencies should ensure that the persons involved in inviting and evaluating tenders understand NSW Government requirements for tendering processes and have relevant skills. Where appropriate, the State Contracts Control Board (SCCB) should invite tenders on the agency's behalf, as provided by the Public Sector Management (Goods and Services) Regulation 1995 (elaborated in section 3). See appendix F for sources of advice on tendering and probity issues.

Accountability

Regardless of whether an activity is performed by an agency itself or by a contractor on the agency's behalf, accountability for the actual delivery of the service, the standards of performance and the overall costs remain with the agency and the Government. Accountability in those respects cannot be delegated. The contractor's responsibilities must be set out in the contract documentation but it is the agency's responsibility to ensure compliance by contractors and also to ensure that appropriate procedures are in place for receiving and considering grievances arising from the contracted activity. Serious breaches by any party with clear responsibilities must be met with appropriate responses.

Monitoring of agencies

Progress by agencies in achieving best value for money will be monitored with an emphasis on substantial improvements both on an agency-by-agency basis and on a cross-agency basis. Surveys of agencies and implementation reviews will be undertaken.

⁴ NSW Treasury (1997), *Contracting for Services in the NSW Public Sector, 1996 Survey Findings*, NSW Treasury Research and Information Paper, and similar publications in previous years.

⁵ Hodge, G. (1996), *Contracting Out of Government Services: A Review of International Evidence*, Montech Graduate School of Government, Monash University, Melbourne.

2.2 Implementing the policy

There are three complementary paths in policy implementation.

1. Performance and cost monitoring

Agencies are to routinely monitor the performance of all significant activities against standards and benchmarks and, based on the results of the monitoring, take action as warranted to improve performance.

It is likely that the monitoring of costs will require the development of accounting information of greater relevance to the task than is currently available. Pending the development of appropriate information systems, agencies should use the best available data for performance and cost monitoring.

In order to establish performance benchmarks, managers will need to actively seek data in relation to comparable activities performed elsewhere. Where such data are not already available, managers should seek relevant data in conjunction with counterparts in other agencies, through professional associations or other appropriate means. In the case of corporate services, the 1996 survey undertaken by the Council on the Cost of Government provides a source of comparative data as at that time⁶.

The essential point is that, subject to the practicalities of doing so, managers should have bases for assessing the performance of the activities they control relative to the performance of others in their profession, industry or field of activity.

2. Planning

Agencies are to incorporate planning for periodic in-depth reviews of activities under service competition policy within their normal planning processes. These reviews may be planned to fit with the normal review activities of the agency.

3. Reviewing activities

In reviewing activities, agencies are to determine and implement the most appropriate approach to realising the best value for money in the performance of the activity. This may include:

- cessation or reduction in the activity if warranted on the basis of lack of need;
- internal improvements;
- competitive tendering if warranted;
- mixed systems of internal and external service providers; or
- joint arrangements with other agencies for a common service provider.

Where appropriate, agencies should seek ministerial approval for the strategy.

When reviewing activities, choosing the manner and form to apply service competition may be complex. For example, current organisation structures can be a poor guide to opportunities for competitive tendering because the possibility of

⁶ Agencies which participated in the survey have been provided with the results. The results are published in the Council on the Cost of Government (1996), *Second Report*. See also the Council's internet site at <http://www.occg.nsw.gov.au>

contracting may never have been considered as a factor in organisational design. It may be necessary to rethink the grouping of activities when exploring alternative service delivery possibilities. Consolidating various similar or related functions in an agency (or across agencies) might generate greater benefits than if best value for money is pursued separately in each case.

In any event, service competition can provide a catalyst for agencies to investigate the implications of different service delivery arrangements and, in the process, rethink how their inputs relate to outputs and outcomes. It is also *iterative*, as agencies learn about possibilities and constraints. Early conclusions about what can and cannot be pursued may change in the light of further analysis or experience gained.

**Risks in
contracting**

Where, following the earlier steps under the policy, including action to improve in-house performance, competitive tendering is being considered, the generic factors to be taken into account are set out in box 3. For example, where there are statutory, legal, policy or practical constraints, including accountability and privacy issues, or a high degree of risk, competitive tendering and contracting may be inappropriate. Conversely, where activities are free of such constraints and where their performance can be measured and can be undertaken by a number of alternative providers, competitive tendering may be appropriate. Section 3 contains detailed guidance on how to implement competitive tendering.

Box 3 Factors To Be Considered When Assessing the Suitability of an Activity for Competitive Tendering

Factors relevant to the suitability of an activity:	The case for competitive tendering becomes stronger:
Future of the activity	- the more certain that provision of the activity continues to be justified, and that it will not need to change substantially.
Statutory, legal, policy and practical constraints, including accountability and privacy issues	- the more certain that the activity (or its major components) is free or can be freed of statutory, legal, policy or practical constraints on contracting.
Degree of risk	- the lower the risks to all parties including the public, the Government and the contractor, taking account of risks during and beyond the term of the contract.
Clarity of need for users of the service	- the more precisely the task can be specified in advance.
Importance of the means of service provision	- the less there is a need to specify the method of service provision.
Ability to measure performance	- the more accurately performance can be evaluated and quality assured.
Degree of competition	- the more certain that a number of firms are able to genuinely compete.
Ease of replacement of contractors	- the more certain that the agency will not be locked in to a monopoly provider; and - the more readily an unsatisfactory contractor can be penalised or replaced without significant interruption to service provision.
Impact on essential skills and knowledge	- the more certain that skills and knowledge essential for the agency to undertake its responsibilities would be retained.
Competence in contract management and administration	- the greater the competence of the agency to manage the competitive and contract management processes for the activity.
Costs and benefits of competitive tendering and outsourcing	- the greater the likely benefits exceed the likely costs.

3 How to undertake competitive tendering

This section presents a ‘how to’ summary of the implementation of the competitive tendering option in service competition, which may be appropriate where efforts to improve in-house performance have not realised the potential for substantial improvement. In-house options such as re-engineering, or simple adjustments to in-house processes, where these will achieve the desired result, may be more appropriate in a given case.

The processes described in this section are outlined below.

- 1. Preparing strategic assessment
- 2. Keeping staff informed
- 3. Preparing a specification
- 4. Investigating the market
- 5. Establishing an in-house bid
- 6. Establishing a market
- 7. Finalising the approach to the market
- 8. Relations with bidders
- 9. Evaluating bids
- 10. Comparing the costs of in-house and external bids
- 11. Contract transition and monitoring

3.1 Preparing a strategic assessment

In attempting to maximise the sustainable benefits from service competition, agencies are faced with a number of decisions regarding what activities could be subjected to competitive tendering and what strategy could best be employed in doing that.

Analysis of activities

An initial step is to undertake a strategic assessment which has the aim of setting the parameters for how competitive tendering could be implemented to best meet the needs and aims of the agency. The strategic assessment needs to be tailored to the context at hand.

In order to clarify the merit of proceeding further towards competitive tendering, particular attention should be given at this early stage to identifying and analysing:

- the risks of competitive tendering and contracting in the particular context; and
- the costs to the agency of implementing competitive tendering relative to the expected benefits.

That will require an analysis of the activities to identify the issues relevant to competitive tendering, including the constraints, risks and opportunities, and whether the constraints and risks can be addressed and the opportunities realised. The analysis should include examination of the factors set out in box 3 in section 2.2.

Individual versus multiple activity contracts

In proceeding towards competitive tendering, a threshold decision for agencies is whether any resulting contract will be structured at the level of *individual activities* (for example, cleaning), or at the level of *multiple activities* that cover whole facilities/operations (for example, property management). This needs to be determined on long term value for money grounds, guided by the individual circumstances of each case and the agency's strategic plans. Agencies may find that means other than competitive tendering, for example organisational consolidation, may provide a better path to achieving cost efficiencies.

Single activity contracts may offer agencies lower risk and provide a better fit with the existing organisation, systems of control and capacities to manage contracts. On the other hand, multiple activity contracts may contain greater risk in certain circumstances, but also provide opportunities for contractors to obtain economies of scale and/or scope, through using innovative approaches to meeting output requirements.

Other points relevant to this issue include:

- numerous single activity contracts may create administrative burdens for agencies in terms of tendering and contract management;

multiple activity contracts may require a greater need for flexibility and for reasonable ‘give and take’ between client and contractor, requiring skilled contract management; and

- if the agency wishes at a later date to re-engineer the entire function of which the activity is a part, or wishes to include the activity (such as cleaning) as a component of a larger contract (such as facilities management), it may be more constrained in doing so by the existence of single activity contracts.

A combination of multiple activity contracts and single activity contracts can be appropriate, with each contract approach selected to fit a specific set of circumstances.

**Maintaining
skills with a
mixed system**

The need to balance risk and control in service competition decisions should be influenced in part by agencies’ ongoing needs to retain skills. Agencies may face a dilemma in implementing competitive tendering if, where there are clear benefits in seeking competitive bids to perform activities, they risk losing strategic in-house skills in doing so. These could include skills relevant to contract monitoring, to the provision of ‘hands on’ advice to Ministers, and to the development of ‘intelligent customer’ attributes in Government.

In this light, one option available to agencies is the creation of a *mixed delivery system*, whereby both private sector and public sector providers are engaged to provide the same services. At the heart of the system is the creation of competitive disciplines and pressures between service providers, and the reduction of risk through retaining an in-house ‘operations training ground’ for in-house retention and development of skills, and for ongoing benchmarking. The mixed delivery system may allow agencies to evolve in the light of experience, and provide a vehicle for continuous improvement. It is also a safeguard against the emergence of a monopoly supplier in any market where that is real risk.

In applying a mixed delivery system, the delivery of a service or package of services can be divided into several similar units geographically or by other means or criteria, some of which are then outsourced and some retained in-house. The scale of each contract must be sufficiently large to make attractive packages of work to stimulate innovation and allow efficiencies to be sought. They must be sufficient in number to obtain the benefit for the agency of competitive pressures for future contracts.

The Roads and Traffic Authority has applied a mixed delivery system in its arrangements for road maintenance: in some cases contracts have been awarded to the private sector for the maintenance of defined sections of the road network, and in other areas in-house teams provide the service through purchaser-provider arrangements.

Another example is the way the Department of Public Works and Services maintains in-house teams which compete with private sector providers for the business of NSW Government agencies. In doing this, the NSW Government develops and retains key skills while enjoying the benefits of competition.

Pilot arrangements

Often the benefits, costs and risks involved in a new endeavour cannot be assessed reliably without practical experience. Hence, where competitive tendering appears to offer considerable promise, a pilot project may be appropriate which:

- enables the agency to develop experience in competitive tendering and managing contract arrangements; and/or
- enables the agency's staff to obtain experience working under a form of contractual arrangement.

A pilot project where competitive tenders are invited would typically cover a representative sample of the activity under review, and must be managed with the same degree of care and commitment to a successful outcome as any other tendering project. The private sector will incur costs in responding to the invitation for tenders and, therefore, there must be a clear understanding within the agency that the work will be awarded to the bidder offering the best overall value, subject to that bid adequately meeting the selection criteria.

Where the prime need is to provide managers and staff with experience working under contractual arrangements, there can be merit in trialing internal contracting for a period as a preliminary to direct competition between internal and external providers. Internal forms of contract, as well as inter-agency forms of contract, are often called 'service level agreements'. As the name implies the agreements state in as precise terms as practicable the agreed levels of service to be provided and, to reflect a contract, the agreed costs.

3.2 Keeping staff informed

Consultation

Staff will be concerned by competitive tendering because of the uncertainty the processes can create. It is of primary importance to: consult with staff immediately an activity is seriously being considered for competitive tendering; to provide opportunities for staff to raise their concerns and have them addressed; to treat staff honestly; and to keep them informed throughout the process. Similarly, the appropriate unions should be consulted early in the process and advised of key developments as they occur. Where practicable, staff and unions should be given opportunities to contribute to developments, including the option of establishing an in-house bid (elaborated in section 3.5).

Staff management plan

Senior managers should also ensure that their intentions to treat staff fairly and equitably are matched by appropriate actions. A staff management plan should be prepared covering communication, consultation and any likely eventualities which may occur. This plan should identify management responsibilities. For larger competitive tendering exercises, a project manager should oversight the overall process and there should be a clear delineation of management responsibilities. Adequate resources should be devoted to ensure plans in relation to staff can be implemented.

Policy

In terms of bidder selection, the Government's policy is that agencies should give preference to bids which include genuine employment opportunities for in-house staff currently performing the activity, subject to the other criteria including value for money being satisfied⁷.

At the time of publication, as noted in section 2, employment issues arising from these guidelines were under consideration by a working party established between the Premier's Department and the Labor Council of NSW and public sector unions. Specific provisions dealing with employment issues will be published separately. If, at the time of implementing these guidelines, an agency is in doubt as to those provisions, immediate advice should be sought from the Public Sector Management Office of the Premier's Department. Telephone numbers for advice on this and other matters are in appendix F.

3.3 Preparing a specification

Once a competitive tendering model is chosen, a specification of the service requirements must be developed to define precisely what the agency wishes to obtain.

Focus on outputs

As far as practicable, the specification should express the agency's needs in terms of outputs and standards of performance rather than detailing how the needs must be met. This allows bidders flexibility and enables the agency to benefit from innovative proposals. It is equally important not to state needs too broadly or to require bidders to develop tailored solutions unnecessarily. Statutory and other essential requirements as to processes must be included.

Performance criteria and standards

Performance criteria and standards should be developed for inclusion in the specification. They will be the determinant of the quality of service and will affect its cost. Care must be taken to ensure that the criteria and standards, at the very minimum:

- do not pre-empt solutions;
- are not biased towards a particular provider, be they in-house or external;
- can be monitored; and
- are realistic and do not specify beyond the needs required.

Relevant policies

Government policies and good management practice in the public sector incorporate the protection of the public interest and the protection of key values such as equity of access and equality of opportunity. In that light, performance criteria and standards included in the specification should encompass, where relevant:

⁷ NSW Treasury (1995), *Treasurer's Financial Statement*, page 51.

- the development and maintenance of service levels that guarantee appropriate client access and choice;
- the recognition in service design and delivery of the particular cultural, life cycle and socio-economic attributes and needs of clients;
- the maintenance of public accountability measures and appropriate performance indicators; and
- where contracts involve the delivery of services to third parties (for example, a contract between the Government and a private company to provide services to the public), the inclusion of appropriate mechanisms for clients to participate in the provision and evaluation of services, and for complaints to be resolved fairly and openly.

Where appropriate, and subject to legal advice in the particular case, agencies may include requirements in the specification or other contract documentation for probity and ethical behaviour on the part of the contractor and the contractor's employees and agents.

Performance criteria and standards should not be inconsistent with the principles stated in the Government's *Social Justice Directions Statement* and the *Principles for a Culturally Diverse Society*, outlined in boxes 4 and 5, and the Government's policies for state and regional development.

Box 4 New South Wales Social Justice Directions Statement

- ***Promoting a more inclusive community*** through recognising diversity as a great strength of the State and breaking down the barriers which prevent access to Government services.
- ***Responding to the needs of families and communities***, in particular by ensuring that everyone has access to basic services and that services are directed to those people who are in poverty or disadvantaged and areas of greatest need.
- ***Providing services and in other ways contributing to a physical environment*** that strengthens family, neighbourhood and community ties.
- ***Ensuring equitable access to a quality public education system and training opportunities***, including those for life-long learning, to better equip all people in NSW for their future.
- ***Reforming the justice system*** so that it better serves the whole community, not just those with the means to make best use of the system.
- ***Helping our democracy work better*** for all citizens by improving public participation in the decision-making processes of Government, ensuring that these processes are open, responsive and effective.

Box 5 Principles for a Culturally Diverse Society

- All individuals in NSW should have the greatest possible opportunity to contribute to, and participate in, all levels of public life.
- All individuals and public institutions should respect and accommodate the culture, language and religion of others within an Australian legal and institutional framework where English is the primary language.
- All individuals should have the greatest possible opportunity to make use of and participate in relevant activities and programs provided and/or administered by NSW Government institutions.
- All NSW public institutions should recognise the linguistic and cultural assets in the NSW population as a valuable resource and utilise and promote this resource to maximise the development of the State.

Input from bidders

In-house providers may contribute to the development of the specification even though they may intend to submit bids. However, where that is the case, particular attention must be given to the maintenance of probity. The input of potential in-house bidders must not result in specifications which are weighted against external competitors. In order to safeguard against the latter, staff connected with the in-house bid must not determine the performance criteria, performance standards and the content of the specification. Additional advice on probity issues in relation to in-house bids is contained in section 3.5.

If practicable, all bidders should be given the opportunity to provide comment on a draft specification during an expressions of interest process. The specification can then be finalised for the tender phase of the competitive tendering process with greater confidence that the specified requirements can be satisfied.

State Contracts Control Board

Where appropriate, agencies should contact the State Contracts Control Board once a specification has been drafted. The Public Sector Management (Goods and Services) Regulation 1995 gives the State Contracts Control Board (SCCB) sole power to tender and contract for goods and services on behalf of agencies listed in Schedule 1 of the Public Sector Management Act. Those agencies must obtain supply of goods and services through the SCCB unless the SCCB has delegated the necessary powers or unless they operate under legislation which provides them with independent contracting power.

The SCCB has delegated authority to agencies to undertake their own purchasing for goods and services costing less than \$50,000. At the time of publication all procurements over \$50,000 must be referred to the SCCB unless the product or service is available through the SCCB's 'period contracts'. In the latter cases, agencies may order directly from contractors without reference to the SCCB. Further details of the delegations are in appendix A.

The Regulation requires that competition be maximised, that probity be maintained and that the offer selected from suppliers be the most advantageous to the public service.

In the context of competitive tendering, it is likely that many cases will be over the \$50,000 level and will not be on period contract. Therefore, agencies will be required to submit full details and specifications to the SCCB, which will invite expressions of interest, tenders or proposals as appropriate. Contact details are in appendix F.

3.4 Investigating the market

Strength of the market

Competitive service provider markets are central to achieving the benefits of competitive tendering. Little purpose will be served by seeking bids if there is no market interest or if competition is weak. An initial assessment of the existence, nature and strength of the relevant market is an important step which might lead to a substantial change in the strategy to be pursued or termination of the competitive tendering process for the particular activity.

The assessment of the market can be undertaken by preliminary inquiries to likely sources of information and by advertising for expressions of interest in providing the service. Both these methods are recommended.

Preliminary inquiries

- Preliminary inquiries can lead to later processes being better attuned to the market. Inquiries can be made to other agencies or non-government and private sector organisations which may have the same need, to industry associations and, where they can be identified, to providers of the services being sought.

Expressions of interest

- Inviting expressions of interest through the press can: disclose market interest which otherwise would not be discernible; lead to identification and short-listing of the most capable suppliers; and provide helpful suggestions and ideas.

An invitation for expressions of interest will be the formal commencement of the competitive process. This step should not be taken lightly.

- Before issuing expressions of interest, staff and unions should have been consulted.
- After this point, industry participants will incur costs in responding to the invitation, will have a keen interest in the outcome, and will be monitoring the agency's management of the processes. It will be essential that probity be ensured and be seen to be ensured.

In addition to assessing the extent of the market, asking for expressions of interest is an important tool for ongoing management of the bidding process. In very competitive markets, a focus on the capabilities of providers enables short-listing prior to the more costly tendering processes. This reduces the costs of tendering for industry and the complexity of tender evaluation for the agency.

Asking for expressions of interest can also be a vehicle for seeking comment on the draft service specification, particularly where the draft is based partly on input from in-house providers.

The invitation to submit an expression of interest should set out:

- the objective/s in inviting expressions of interest and the intended steps in the process (with the qualification that the agency may change course or not proceed further);
- information relating to the service being sought, which can include the draft specification;
- the nature of the information sought from respondents; and
- the criteria for short-listing.

Fair dealing

Fair dealing with all bidders should be a paramount consideration and care must be taken to respect commercial confidentiality. When seeking ideas through an expressions of interest process, prospective bidders should be informed if the agency intends to use the best ideas in a specification to be issued in a later tendering process. In some cases the ideas may constitute intellectual property which cannot be used without the permission of the holder of the rights of the property. Legal advice should be sought on this issue, as warranted.

As noted in section 3.3, agencies covered by the Public Sector Management (Goods and Services) Regulation must comply with any requirement to submit documentation to the State Contracts Control Board for action to invite expressions of interest and tenders, unless appropriate delegations have been made.

3.5 Establishing an in-house bid

Encouragement of bids

The benefits of service competition policy arise from competition and not necessarily from whether the private or public sector undertakes the function. In recognition of this the option of contracting to in-house service providers must be fully assessed and, where appropriate, in-house providers should be given every opportunity to lodge a bid that is assessed on an equal footing with bids from external contractors. An in-house bid refers to a situation where an internal team, often based on the existing internal service provider, participates as a competitor in a tender process.

The policy to encourage in-house bids does not mean that in-house bids should be encouraged in unwinnable situations. There are some areas where the private sector will have advantages which cannot be matched within a single agency. For example, these include where the private sector has the benefit of economies of scale and/or access to technology and skills not available within the government agency.

These cases are those where outsourcing, through competitive tendering, is most likely the best option.

Preparation for competition

Implementation of the policy requires the proper and accurate costing of in-house options. It may also mean organising in-house providers into separate business units. The costing of in-house bids is discussed in section 3.10.

The in-house bid team must ultimately be able to put in a bid based on the minimum resources required to meet the terms of the contract, which at times may differ from the resources currently used to perform the task. The in-house team should not be burdened with any inefficiencies that may exist as a result of past decisions.

Assistance

The interests of the agency and its staff are served by ensuring that existing in-house providers are given adequate time and assistance to prepare for competitive tendering. Provision of adequate time and assistance can:

- provide early improvements in efficiency and/or quality;
- enable the agency and staff more time to absorb the impacts of the reform processes, including any early redeployments and redundancies which result from in-house initiatives; and
- help produce an outcome where external bidders will compete against an efficient in-house team that is already in place.

The length of time required by in-house providers will vary in different cases depending on the complexity of the competitive tendering project and the characteristics of the existing service delivery arrangements. The assistance provided may include access to expert advice in relevant areas such as employee issues, re-engineering, costing and tender proposals. Without such assistance the aim to provide fair and equitable opportunities for staff and to ensure a competitive basis for tendering may not be realised.

Funds for providing assistance should be set aside when agencies commence the process of planning and implementing competitive tendering. Agencies should articulate clearly in advance the amount and type of assistance to be provided and the dollar value of assistance must be justifiable in the particular circumstances. Ten percent or less of the current annual full cost of the activity can be used as a guide for this purpose.

Critical requirements

There are a number of important requirements to be applied in relation to in-house bids in order to ensure a fair and competitive bidding process and compliance with the principle of competitive neutrality.

- There must be full physical and functional separation of the competitive tendering project team and its activities from all staff and managers involved in the in-house bid.

- While personnel connected with the in-house bid may be asked to provide information which assists development of the tender specification and other documentation, they must not determine the performance criteria, performance standards or the content of the specification or of other tender documents or any other matter connected with the conduct of the bidding processes.
- The in-house team must be given the same opportunities as external bidders to obtain information related to the bidding process and be neither advantaged nor disadvantaged in that regard.
- The same documentation required of external tenderers should be completed by the in-house bid team (with the possible exception of requirements related to the financial standing of private bidders), and be lodged in the same manner and same place and by the same time that applies to external bids.
- The costing of the in-house bid should be in accordance with the advice on costing in section 3.10 and appendices B and C of this guideline, including the requirements to include imputed taxes in accordance with the requirements for competitive neutrality.
- The evaluation of the competing bids must be based on pre-determined criteria set out in the tender documentation issued to all bidders, be objective and avoid bias towards either the in-house or external bids.

If these requirements are not met or are not believed by bidders to have been met, the credibility of the tender process will be undermined, the private sector may lose interest in bidding for services in cases of in-house bids and the best value for money is unlikely to be realised.

Prospective tenderers should be made aware in the tender documentation of these arrangements. An additional safeguard in particularly complex cases is to appoint an independent ‘probity auditor’ to monitor the processes from the pre-tender stage until the selection of the successful bid, and to provide a point of reference for bidders with concerns⁸.

3.6 Establishing a market

It is important that in implementing competitive tendering, agencies act to promote competitive outcomes. There can be various actual and potential barriers to competition and the agency’s approach can play a major role in addressing these. The barriers can include those discussed below.

⁸ A guide to the use of probity auditors is in Independent Commission Against Corruption (1996), *Probity Auditing: When, Why and How*.

Advantages of incumbency

It is often the case that incumbent suppliers, when acting as in-house bidders, may possess a familiarity with client or operation data and information that may give them strategic advantages over external bidders. Agencies should ensure that, when implementing competitive tendering, external bidders are provided with sufficient data and information to enable them to compete on a fair basis with in-house bids.

Monopolies

As a general rule, agencies should try to avoid, where practicable, outsourcing to a monopoly supplier. In cases where there are two or very few suppliers and the case for applying competitive tendering is strong, agencies will need to carefully plan and monitor the process. This can be especially relevant in rural areas where the level of competition can be less than that present in the larger cities.

It is also often the case that some services, once established, become natural monopolies because of high set-up costs in infrastructure. In such cases, agencies may consider separating out the elements which have competitive characteristics, from those which are prone to natural monopoly. For example, the Government's electricity reforms separate power generation from distribution, and contain different competitive strategies for both elements of the system.

Narrow specifications

Specifications which set out preconceived and detailed design needs may limit options and competition. This can be most marked in cases where particular products, such as software, are specified. As discussed in section 3.3, a specification expressed in terms of outputs and standards, as distinct from processes, broadens the options and may foster competition.

Contract size and length

Contracts which are small and/or short may not stimulate interest, whereas those which are large and/or lengthy may mean only the largest suppliers can participate. Consideration should be given to bundling services into attractive packages that can be offered as one contract, or, conversely, splitting an activity among more than one contract in order to foster competition. A judgement must be made each time as to the costs and benefits, but it should explicitly take account of its impact on competition.

Agencies should determine contract size on a case-by-case basis, with reference to:

- the service and market characteristics such as economies of scale and the potential for innovation within firms;
- administrative, transaction and change-over costs; and
- the need to ensure competition.

Contract length should be determined with reference to:

- the need for contractors to recoup significant sunk costs;
- the desirability of continuity of client-contractor relationships, particularly in community services;

- the possibility of fundamental policy changes affecting service provision; and
- the need to ensure an effective level of competitive pressure.

When developing the specification and the contract, and when later considering proposals by bidders, agencies will need to consider whether the arrangements might infringe the Trade Practices Act. This may be the case, for example, if the size or the length of the contract or any other factor in the arrangements could have anti-competitive consequences.

Maintaining competition

Competitive tendering should be implemented in a way which not only establishes a competitive context for bids, but which ensures ongoing competition. It is important to create conditions that do not restrict future rounds of competitive tendering or the introduction of flexible alternatives for service delivery.

Achieving these goals will demand different actions in different circumstances. However, a key issue common to many cases is the need to ensure retention of ownership of any key data and information which is required:

- by the agency for any good reason, such as to monitor the service; and
- by competitors if they are to make a sound and realistic bid at the time of re-tendering.

3.7 Finalising the approach to the market

When approaching the market, documents should be prepared with the aim of minimising the scope for misunderstanding by bidding parties. This means that documents should be written clearly and should have a level of specificity consistent with the needs of bidders.

Tenders or proposals

Tenders are firm offers from bidders which can often be accepted without further discussion apart from some of the details, whereas proposals do not necessarily commit the bidder and will usually anticipate considerable discussion and negotiation. The choice between seeking tenders or seeking proposals will be dependent on the complexity of the case, the scope for bidders to propose designs for the service, and the ease of comparability of the bids.

Tenders are usually invited in cases where the service required is straightforward in nature, the private sector is known to have the capability, and the differences between bidders will be easy to compare, such as expertise, experience and the total cost.

Proposals are usually invited in cases where the service required is complex and a key variable will be the different methods of service delivery offered by bidders. Proposals are also appropriate in complex cases where a ‘partnership’ style relationship with shared risk and reward during the term of the contract is being sought. Often, following the receipt of proposals, a preferred proponent is determined by applying the selection criteria, and the details of design and cost are finalised through negotiation. In the event that those negotiations fail, negotiations can commence with the next preferred bidder and so on. If an acceptable result does not occur, fresh bids can be called or the strategy can be reviewed.

Whichever approach is chosen, it is critical to explain to prospective bidders exactly what is being sought and the process which will be followed. Where relevant, tender and proposal documents should be forwarded to the State Contracts Control Board (see section 3.3 above), and should be consistent with advisory publications of the Independent Commission Against Corruption (see appendix F).

Inclusions in documents

The package of documents issued with the invitation for tenders or proposals should have the following inclusions.

The specification

The specification should include an unambiguous statement that enables a clear understanding of the purpose of the activity being tendered (elaborated in section 3.3).

Operating context

There should be a description of the context within which the function lies, to alert tenderers to the issues and subtleties facing the service provider. Items to be included may be the nature of the business functions undertaken, geographical locations of the agency, and relevant internal or public reports and plans.

Bidders should be informed of any obligations an external contractor will have in relation to various public sector legislation (such as Freedom of Information and Archives legislation). Different situations may apply in different cases. Where any such obligations can be subject to legal dispute, agencies should obtain advice and, if appropriate and practical, include them in contracts.

Background information

Documents should refer to the availability of background and statistical information to enable bidders to fully understand the relevant issues and to make a sound assessment of the costs and risks. In general, it is in the agency’s interests to make available all relevant data and information which reasonably can be sourced.

Selection criteria

Tender or proposal documents should clearly spell out the selection criteria to be used. Selection criteria could include:

- meeting the specification;
- total cost of service provision;
- quality assurance proposals;
- demonstrated track record in the service or in a related area;
- previous and/or future commitments to equal employment opportunity;

- financial stability of the firm and/or the principals;
- calibre of the key people proposed to be involved; and
- proposals in relation to employment of in-house staff currently performing the activity.

Briefing sessions

Documents should include details of any pre-tender briefing sessions to which all prospective bidders are invited (elaborated in section 3.8).

Likelihood of in-house bid

The documentation should foreshadow any likely in-house bid. Bidders should be advised of the requirements for ensuring competitive neutrality and impartial assessment, including the requirement for the in-house bid to be lodged at the same time as external bids (elaborated in section 3.5).

Submission details

Documentation should provide a guide to how responses should be structured, and the timetable for assessing bids.

Employee issues

Bidders should be:

- advised that it is the Government's policy to give preference to bids which include genuine employment opportunities for in-house staff currently performing the activity, subject to the other criteria including value for money being satisfied; and
- if relevant, asked to outline the employment opportunities which would be available to existing staff.

Any detailed requirements or options in relation to existing staff should be consistent with policies issued by the Public Sector Management Office of the Premier's Department.

Conditions of contract

To the extent they can be drafted in advance, contract conditions should be included in tender documents. Where tenders are to be called, virtually complete conditions of contract should be included in the documentation issued to bidders. In the case of proposals, the extent of coverage of the conditions at the invitation stage will vary from case to case.

Conditions common to most contracts relating to competitive tendering include:

- term of contract;
- responsibilities and obligations of the parties;
- insurance requirements;
- risk allocation;
- payment procedures;
- dispute settlement and termination provisions; and
- variations provisions.

In addition, agencies should be alert to the following issues for possible inclusion in contracts:

- ownership and maintenance of assets and data;
- mediation provisions⁹;
- incentives and penalties;
- conditions under which agency infrastructure or services are used;
- confidentiality;
- contract administration and monitoring;
- conditions for access/ownership and/or destruction of client records or other data;
- processes for the change-over of contractors at the end of the contract;
- protection from assignment and sub-contracting;
- requirements for compliance with laws including anti-discrimination, Freedom of Information; and
- requirements for compliance with Government policies, potentially including environmental policies, social justice policies, multi-cultural policies, and policies for state and regional economic development.

3.8 Relations with bidders

Answering questions

During the period between issuing the invitations for the tenders or proposals, and the closing date for submissions, it may be the case that agencies will be required to field questions and provide information to bidders. It may also be the case that agencies arrange briefings with bidders to explain key points.

The key principle in agencies' dealings with bidders is that all bidders should be given equal access to information. If a briefing session is held, the session should be minuted and the minutes circulated to all prospective bidders whether or not they attended the session.

In addition to these arrangements, agencies may choose to institute further processes to ensure bidders are given equal access to information. This can include: (i) recording any information given to prospective bidders individually and to circulating that information to all other prospective bidders; and (ii) agencies requesting that all queries be in writing (including facsimile where a quick response is needed). Whichever approach is decided, the important principle is that bidders are informed in advance of arrangements.

⁹ *Public Sector Mediation Guidelines* were issued with the Premier's Memorandum 97-15, July, 1997.

3.9 Evaluating bids

In comparing bids, it is essential that probity be maintained, and that the evaluation is objective, rigorous and is based on the pre-determined criteria issued with the invitation to tender. In order to facilitate these aims:

Evaluation team

- an evaluation team should be established comprised of people with competence in tender evaluation, knowledge and skills concerning the relevant operational area, and financial skills;
- no member of the team should be part of an in-house bid or have played any part in developing the in-house bid, where one is lodged;
- the team should have access, as warranted, to sound sources of advice on technical, legal, financial, or other issues¹⁰;
- to ensure impartiality, at least one member of the team should be from outside the organisation;
- an evaluation plan should be prepared by the team covering the resource requirements for evaluating bids, the time frame for bid evaluation with significant milestones (for example, evaluation of written proposals and any discussions of proposals with bidders), and processes for consultation, negotiation and de-briefing with bidders;
- team meetings should be minuted; and
- the reasons for the team's recommendations should be recorded in a manner which can be subject to external scrutiny.

Issues to consider

In evaluating bids, the overarching principle should be to achieve long term value for money. It should be emphasised that this goal does not always equate to lowest tender price. Achieving long term value for money requires consideration of six broad areas.

Capabilities

The evaluation should include the experience of the firm, the capability and qualifications of the key personnel who will be operating the contract, the commitment of the firm to equal employment opportunity, and the capability of the contractor to work within the relevant policy frameworks of government. Reference checks are essential.

Contractors will experience normal turnover in personnel and, hence, well qualified personnel allocated to contracts may not be available for all or a major part of the contract.

¹⁰ This can include, for example, arranging for a qualified accountant to verify the costing and financial assumptions in bids, including an in-house bid, or for an experienced contract lawyer to examine the conditions proposed by bidders, or for an independent expert in the relevant activity to assess the technical soundness of the servicing methods proposed in bids.

Therefore, a contract should not be awarded on the basis that individual staff members will continue to be employed, except for consultancies and short term projects.

Technical qualities

The evaluation should establish whether the tender exactly meets the requirements set out in the specification. For example, where the contractor's own plant, equipment and site are proposed to be used, their capacity to meet workload and quality requirements should be verified. Any modifications proposed in the bid should be checked for acceptability.

Contract variations

The evaluation should appraise the acceptability of any contractual qualifications or variations stated in the offer, particularly where these propose variations to schedules of delivery or quality. The cost and other effects of any acceptable qualifications will need to be taken into account.

Finances

The evaluation should identify all relevant costs of bids and convert these to net present values. Costs to be assessed include: initial (once only) costs; the on-going costs associated with maintaining services; the contracting administration and monitoring costs of the agency; any transition costs such as retraining, redeployments and redundancies; the costs of any losses to economies of scale within agencies¹¹; and, change-over costs at the expiry of the contract. (Financial issues are elaborated in section 3.10 and appendices B, C and D.)

Sensitivity to change

The evaluation should take account of the sensitivity of the financial assessment to changes in key variables, such as demand, and what this means for the cost of service provision.

Longer term issues

The evaluation should consider any longer term implications of contractor failure and the risk of being locked into one provider. Where plant and equipment is involved, the likely state of plant and equipment at the time of renewal and the need to plan ahead for public or private capital replacement will require consideration.

Longer term issues such as these should have been considered at the pre-tender stage leading to any appropriate inclusions in the invitation for tenders or in the specification. However, these issues may often require further consideration during tender evaluation, particularly where the approaches set out in tenders raise relevant issues.

¹¹ For example: where an agency contracts out a large proportion of its activities, it may lose economies in purchasing or other corporate support functions.

3.10 Comparing the costs of in-house and external bids

Tender documentation from in-house and external bidders needs to include calculations of anticipated resource requirements. This will generally involve the bid price, plus details of any other resources the bidders require (for example, a tender for a cleaning contract could include the bid price plus details of space required for equipment storage and other purposes).

Net avoidable costs

The team charged with evaluating bids needs to compare tenders on the basis of their *net avoidable cost* implications, expressed in *net present value* terms. Net avoidable costs are defined as all those which would be avoided if performance of an activity is transferred to an external party¹². The principles are elaborated in appendix C. The relevant costs generally include both the direct costs of undertaking an activity (e.g. salaries), and estimated avoidable components of indirect costs (e.g. rent) incurred when an activity is undertaken in-house.

Cost components

Direct and indirect cost items which may need to be considered in identifying the avoidable costs of current arrangements are shown in box 6¹³. Other factors pertinent to calculating the net avoidable costs of competing bids are discussed below.

¹² Industry Commission (1996) *Competitive Tendering and Contracting by Public Sector Agencies*, Report 48, page 310.

¹³ Appendix D provides a proforma.

Box 6 Cost Components

- Staff costs
 - wages and salaries including overtime and allowances
 - superannuation costs
 - long service leave
- Executive management costs
 - management costs not included elsewhere
 - monitoring costs
- Accommodation
 - rent, or if owned, the realistic opportunity cost expressed as rent
 - maintenance
 - consumables such as electricity
- Equipment and furniture
 - maintenance
 - replacement costs
 - insurance
- Materials
 - purchase costs
 - warehousing
- Other running costs
 - travel and allowances
 - telephones
 - postage
 - stationery
 - printing
- Administrative, specialist and other costs not elsewhere included
 - corporate service costs such as recruitment, payroll, training, accounting, invoicing, legal etc.; and
 - consultants and other special services.

Discount rate

In many cases, the comparison of in-house and external bids will need to take into account the fact that bids might possess different cost and revenue streams. To convert bids to a common base requires calculation of their discounted present values. Appendix C provides a detailed discussion of this process. Advice on the appropriate discount rate will be contained in the NSW Treasury's *Costing Guidelines* which are expected to be published in late 1997.

Costs of preparing an in-house bid

In-house bidders should estimate the direct and indirect costs associated with preparing their bid, and include this information in tender documentation. This information should be used by the evaluation team for background purposes, but should not be included when comparing in-house and external bids. (Bid preparation costs should not be included in comparisons of in-house and external bids because they are sunk.)

Transition costs

Where transition costs arise from the shift from in-house to external service provision, they should be included in the evaluation of competing bids.

Redundancy expenses

Where bids imply different redundancy expenses, the present values of these expenses should be calculated relative to a benchmark of what is an efficient level of staffing to undertake an activity. For example, if an activity to be made subject to competitive tendering currently has a staffing level of 20 full-time positions but the agency estimates that an efficient level of staffing is 15 full-time positions, then the present value of redundancy expenses should be incorporated into bid assessments relative to 15 full-time staff (rather than the existing level of 20 staff).

Contract monitoring costs

Contract monitoring costs should be estimated and, where there are anticipated differences between the costs for monitoring in-house and external bidders, or between different external bidders, these should be taken into account when comparing bids.

Contract cessation costs

In some cases the cessation of a contract, particularly if undertaken by an internal or external service provider, may involve specific costs. These could include, for example, removal of equipment or formal contract reviews. Where relevant, these should be anticipated and included in estimates of competing bids.

WorkCover liability

Agencies should obtain advice on the implications for workers' compensation liabilities arising from any shift from in-house to external service provision with a view to ensuring (i) appropriate coverage is in place, and (ii) 'double' payment is not made.

Adjustments for tax exemptions

Additional to these costing principles, in-house bids need to be adjusted to take into account their exemption from input taxes. This requirement is intended to facilitate bids being compared on grounds of competitive neutrality. In-house bids should be adjusted to include nominal payments of input taxes, including: payroll tax, sales tax, land tax, local government rates and charges, stamp duties, financial institutions duty and relevant excise charges. Adjustments for income tax should not be made¹⁴. Further discussion of this issue is contained in appendix B.

Sensitivity analysis

The analysis of bids can be highly dependent on the choice of discount rate. For example, the higher the discount rate, the more up-front costs, such as redundancy expenses, will affect the net present value of comparative bids. Therefore, to test the extent to which the analysis is subject to the choice of discount rate is important.

It is recommended that a discount rate two percentage points above and below the Treasury rate be used to test how robust the analysis is to variations in interest rates. As a rule of thumb, if bid A is cheaper than bid B in net present value terms at, say, 3% and 5% discount rates, but not at 7%, A is preferable to B, and *vice versa*. If bid A is cheaper at 3%, more expensive at 7% and line-ball at 5% than bid B, the comparison of bids rests on the treatment of transition costs, such as redundancy expenses, or external contract set-up costs.

¹⁴ The exclusion of income taxes for competitive neutrality purposes is discussed in the Industry Commission (1996) *Competitive Tendering and Contracting by Public Sector Agencies*, Report 48, page 306.

It then becomes a matter of judgement about deciding which bid offers the best value for money over the life of the contract, based on a balanced assessment of all of the facts.

In these cases it is important to reassess the estimates of costs included in the analysis. Major cost items subject to uncertainty, such as contract transition costs, should also be tested using sensitivity analysis, based on best case, worst case and likely case scenarios.

The agency will then have an array of possible net present value outcomes under different possible future circumstances on which to make informed decisions at this point in time.

**Individual
versus conjoint
decisions**

In competitive tendering, it is important to recognise that a decision to either 'make' or 'buy' a particular service can be optimal when considered of itself yet not optimal when considered as part of a larger, more holistic decision. For instance, there may be little in the way of avoidable overheads when one particular function is outsourced but much greater potential savings when that function along with other more or less related activities are all outsourced. This is likely when several activities rely on a 'common' or shared overhead (e.g. rent). It may be that each of these activities is, when considered individually, better undertaken in-house (since no rent cost is avoided), yet overall costs are reduced when all are outsourced (and all rent cost is avoided). The lower cost outcome requires, therefore, that decisions be made globally rather than individually.

This problem can only be averted if decision makers are conscious of synergies and economies of scale which conjoint decisions offer¹⁵. It is difficult in a large and complex organisation to take account of all possible synergies, however some will be obvious and others will be revealed without much trouble. In fact, given the tradition in public sector administration of various individual entities (e.g. agencies) and sub-entities making decisions individually rather than in concert, there are almost certainly opportunities for co-operative acquisition and provision of services.

3.11 Contract transition and monitoring

If a decision is made to engage a contractor to replace an in-house activity the change-over will need to be managed with much care and skill.

**Transition
management**

The degree of competence and sensitivity demonstrated in human resource management during such a process will impact on staff in the particular area and can influence attitudes of staff throughout the organisation.

¹⁵ Sometimes there are economies of scale which are lost when just a single function is outsourced. For instance, some desirable social or community service may be viable in conjunction with another but not of itself. This can occur when there is a common (shared) overhead cost.

By this time, staff should have been well informed of the options available to them and a change-over plan focusing on employee issues should be in place.

In cases where an in-house bid is unsuccessful, staff should be notified immediately and a formal de-briefing session held. Any unsuccessful external bidders should be notified in writing and, if appropriate, be provided with an opportunity to discuss the strengths and weaknesses of their bid against the selection criteria (but not against details of the successful bid).

The introduction of a contractor to an organisation must be managed with attention to other relevant issues including:

- clarity of managerial responsibility for the implementation of the decision to award the contract;
- requisites which must be satisfied prior to the contractor commencing operations, such as explicit agreement in the appropriate legal form between the parties and satisfaction by the contractor of insurance and other essential requirements;
- fulfilment by the agency of all its responsibilities under the contract, such as the readiness of the site for contractor occupation, understanding by affected employees of the operational arrangements, and timely payments; and
- appropriate monitoring arrangements.

Monitoring

Whether the work has been awarded to an in-house operation or to a contractor, the operating arrangements should not allow relaxation of the successful bidder's commitments to costs and quality. This should not be taken to infer an adversarial relationship. In general, the arrangements put in place should reflect the positive view that all parties will do their best to comply with the objectives and the spirit of the contract.

Monitoring, which applies to both in-house and external service providers, should occur on two levels:

- a joint consultative body which meets periodically; and
- day-to-day monitoring through normal agency operations, administered preferably by a contract manager.

Monitoring arrangements should be guided by agreed performance indicators that include, where appropriate, feedback from clients and/or third party users. The benefits generated by effective monitoring are significant in terms of encouraging improved performance, assisting in the future design of specifications and contracts and ensuring adherence to the terms and spirit of the contract.

In the case of in-house operations, any proposed efficiency improvements on which the bid was based must be implemented and the projected costing met or bettered. The monitoring of outputs and costs should not be different from that applicable to an external contractor.

The managers of the in-house operation will need to be aware that they must stay abreast of industry developments and maintain their competitive position. At the end of the agreed contract term, the operation will need to be competitive if it is to succeed again.

In the case of external contractors, there may be merit in an agency adopting a ‘partnering’ approach to contract monitoring and management. This involves working co-operatively to achieve joint objectives, through open communication and the adoption of dispute avoidance procedures. It requires a spirit of co-operation between the agency and the contractor for mutual gain. Development of partnering arrangements must not undermine the formal terms of the contract between the parties; legal advice may be appropriate to safeguard against compromising the agency’s legal position in that respect. Ideally, partnering as envisaged here would complement, rather than undermine, the formal terms of the contract.

Repeating the cycle

Towards the end of the contract period it will be necessary to consider any options in the contract and/or the renewal of the competitive process. A systematic and rigorous re-appraisal will be needed which covers the requirements of the agency, future directions relevant to the function and lessons from experience.

APPENDIX A DELEGATIONS BY THE STATE CONTRACTS CONTROL BOARD (SCCB)

The following are the delegations made by the SCCB under the Public Sector (Goods and Services) Regulation, 1995, which were current at the time of publication of this document.

These delegations of legal authority to procure goods and services do not replace the need for an agencies to act within the delegations by their Ministers to incur expenditure.

If there is a suitable period contract

A period contract (or 'common-use' contract) is a formal arrangement with a supplier to provide on request products and/or services at agreed rates and conditions for an agreed period. Through the SCCB, the period contract system covers some 100,000 items and services for offices, schools, hospitals, workshops and other establishments.

If there is a suitable period contract it should be utilised. Orders can be placed directly with the contractor. If there is more than one contractor for the type of item, agencies should match their needs with the alternatives offered and chose the most suitable alternative.

An exception applies to agencies located in country areas. Country offices and other establishments may make local purchases of up to \$1,000 each in value provided that this is administratively advantageous.

If there is not a period contract

If there is not a suitable period contract and if the value of the procurement or disposal is over \$50,000, agencies are required to submit full details and specifications to the NSW Supply Service or the Information Technology Service for the invitation of bids by the SCCB.

If the value of the procurement or disposal is not over \$50,000 agencies may arrangement the procurement or disposal in accordance with the following.

Value over \$10,000 and up to \$50,000: A minimum of three quotations must be obtained in writing.

Value over \$1,000 and up to \$10,000: A minimum of three quotations must be obtained, either verbally (including by telephone) or in writing.

Value up to \$1,000: Agencies are not required to seek quotations provided that:

- (a) rates are considered reasonable and consistent with the market rates for items of a like nature;
- (b) requirements are neither split into components nor a succession of orders for the same goods or services in order to keep each procurement below \$1,000; and

- (c) regular reviews are undertaken to ensure reasonableness of prices, including random invitation and documentation of three quotations at appropriate time intervals.

Inquiries

General inquiries may be made to the NSW Supply Service (02) 9339 7338 or the Information Technology Service on (02) 9339 7675.

APPENDIX B TREATMENT OF TAXATION COMPETITIVE FOR NEUTRALITY PURPOSES

The requirement to make adjustments for taxation exemptions is not intended to result in costly exercises to precisely calculate the appropriate imputations. The materiality of the exemptions should be a prime consideration when determining the order of accuracy appropriate and, as with other aspects of costing, judgement will be required.

The potentially relevant taxes include payroll tax, sales tax and excise, stamp duties and financial institutions duty, land taxes and local government rates. The appropriate treatment varies amongst these as noted below.

Payroll tax

Payroll tax is charged by the NSW Government as a percentage of the payrolls of larger employers. Payroll tax is already included in agency budgets and, therefore, is an actual cost to be dealt with in the costing calculation.

Land tax

Land tax need not be calculated if the organisation is paying a commercial rent for the relevant property. In those cases the lessor will be meeting the tax obligation, which would be reflected in the rent. Similarly, if the costing imputes a commercial rent for the property, and this is done by expert assessment, it may be assumed that the imputed rent covers the cost of the tax. If neither of those conditions hold, an assessment of the tax obligation must be made and reflected in the costing.

Local government rates

Local government rates should be treated much the same as land tax in that if a commercial rent is being paid or has been imputed, the rates may be assumed to have been included. If those conditions do not hold, appropriate rates must be determined and reflected in the costing.

Sales tax

Sales tax is a tax that is generally charged on the wholesale value of goods. For costing an activity, the recommended approach is to determine the tax rate which most commonly applies to the range of goods in question and to apply that to the whole. There may of course be significant items for which the tax will need to be calculated separately but these should be exceptions to the rule.

Financial duties

Financial duties are levied on transactions within taxpayers accounts with financial institutions. In some cases the value of the exemption will be insignificant. As with the other taxes, the financial significance of the exemption will be the key to determining the level of accuracy appropriate.

Income tax need not be imputed.

APPENDIX C COMPARING THE COSTS OF IN-HOUSE AND EXTERNAL BIDS

This appendix introduces and illustrates the principles used to assess the financial merits of in-house and external bids, and describes the methodology for doing this. Note that cost is only one of the criteria that is to be used in the assessment of bids. The overarching aim of competitive tendering is to achieve long term value for money for the NSW Government which requires consideration of a number of other factors: capabilities of the firm etc., quality, acceptability of contract variation, sensitivity to change and the risks associated with being locked into a particular provider (see section 3.9 for further details).

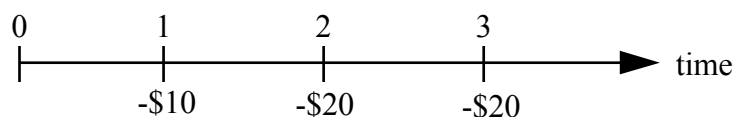
Lowest present value

Competing bids for providing a good or service each represent a stream of costs. These can be compared in terms of discounted present values, where the optimal bid is that with the *lowest present value (PV) of costs*.

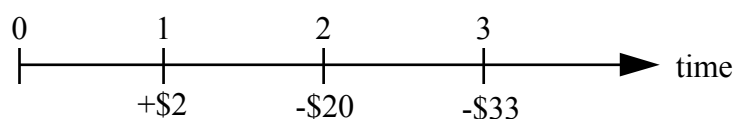
Decision rule: Minimise the PV of costs

To show the workings of this rule, consider the simplified cost (cash flow) streams represented on 'time lines' as follows:

Option A: In-house



Option B: Outsource



'Time 0' is 'now' (the decision point) and projected cash inflows (outflows) are shown as positive (negative) numbers. Note that option B shows a net cash inflow at 'time 1' - as can occur when there is a disposal of capital equipment upon outsourcing. The other cash flows are all negatives. Using a discount rate of 6%, the present value of option A is, by the usual mechanics¹⁶:

$$-10 \times (0.9434) - 20 \times (0.8899) - 20 \times (0.8396) = -\$44.02$$

¹⁶ The present value factor appropriate to each cash flow is given by $1/(1+r)^t$, where r represents the chosen discount rate (here 6%) and t represents the time at which the cash flow occurs (e.g. for $r=6\%$ and $t=2$, the appropriate factor is 0.8899).

and for option B:

$$2 \times (0.9434) - 20 \times (0.8899) - 33 \times (0.8396) = -\$43.62.$$

Therefore, the better alternative is option B which has the lower PV of the two possible cost streams.

Note that if costs were not discounted to allow for timing (i.e. in effect a discount rate of 0%), option A, with total costs of \$50 over three years, would have been preferred to option B, which has total costs over that time of \$51.

**Avoidable
(relevant)
costing**

The avoidable costing methodology embodies a fundamental principle: it is only the costs which are affected by actions which matter. Put another way, the avoidable or relevant cost of an action is the cost which is avoided (not incurred) if that action is not taken. All other costs will be incurred regardless, and, therefore, are of no relevance when deciding whether or not to take that action. For example, if the costs of a support (overhead) function, such as personnel, will stay the same even if an activity is outsourced, then this cost is not avoidable and, therefore, not relevant to the decision on whether to outsource. By comparison, direct wages are usually avoidable and, therefore, relevant.

**Net avoidable
costs**

Net avoidable costs are arrived at by taking the costs of insourcing and subtracting the costs of outsourcing. For example, if periodic wages fall from \$100,000 (insourcing) to \$20,000 (outsourcing) then the net avoidable wages cost per period is the difference between these, that is \$80,000. Rather than working with two distinct cost streams or time lines, as above, it is possible to work directly with just the stream of net avoidable costs (differences), and, therefore, to calculate only one PV figure rather than two. Sometimes it is more natural to assess just the differences between costs across the alternatives rather than to identify total costs under each individually.

Using the example above, the PV of avoidable costs methodology can be applied as follows.

Year	Net Cash Flows		Net avoidable cost
	Option A <i>Insourcing</i>	Option B <i>Outsourcing</i>	
1	-10	+2	12
2	-20	-20	0
3	-20	-33	-13

Assuming that insourcing and outsourcing are equal on the other criteria, outsource only if the PV of net avoidable costs is of the right sign (i.e. positive, if avoidable costs are shown as positive numbers, as above).

In the above example, discounting the net avoidable costs gives a positive result:

$$12 \times (0.9434) - 0 \times (0.8899) - 13 \times (0.8396) = \$0.40.$$

The result is a positive number (note that it is equal to the net PV of outsourcing, negative \$43.62, minus net PV of insourcing negative \$44.02) and so on cost grounds outsourcing would be at a minor advantage¹⁷.

Decision rule: On the cost criterion, outsourcing is preferred if the PV of net avoidable costs is positive

Identifying avoidable costs

There is a fundamental distinction in accounting between direct costs and indirect costs. The 'direct' costs of a particular 'cost object'¹⁸ are those costs which are incurred directly and unambiguously because of its existence. For example, if performance of an activity requires the lease of a truck, then the lease premiums are a direct cost of that particular activity. Other costs, while partly attributable to a given activity, are more indirect. For example, the acquisition and use of a truck in the performance of an activity adds to the costs of an organisation's fleet management group, however this addition may not be obvious or even observable. Such costs are referred to as 'indirect' or 'overhead' costs, and are regarded as attributable in some part to the activity in question yet not in an unambiguous or readily measurable way.

Direct and indirect costs

The direct costs of an activity are usually avoidable. This is not true generally of indirect costs because there is often little or no change, either immediate or otherwise, in indirect costs when an activity is outsourced. The costs of fleet management are an example of how an overhead is often unaffected by marginal changes in activity levels. Indeed in the short run, when the fleet managers have the problem of re-negotiating leases, their costs can actually increase rather than decrease. Where indirect costs can be avoided, there is almost always an intermediate period in which they are the same or higher than previously.

¹⁷ This is merely another way to say that outsourcing is preferred if the PV of its costs is lower than that of insourcing. More generally, if there are two or more external bids, the decision rule is to maximise the PV of avoidable costs (i.e. to select the supplier so as to maximise the PV of avoidable costs). In cases where the in-house supplier is no more costly in PV terms than any external supplier, the maximum possible PV of avoidable costs is zero. Where there is an external supplier with lower PV of costs, the maximum PV of avoidable costs is greater than zero. Contracting out is economically rational only when this is the case; that is, when the PV of avoidable costs is greater than zero. A PV equal to zero means that there is zero "added value" (in net PV terms) from outsourcing and, a negative PV means that the value added is negative.

However, there is a theoretical argument for outsourcing only when the PV of avoidable costs exceeds not merely zero but some value $v > 0$, where v represents the value of the option to contract out. This is the option to choose either to outsource or insource, which, like other options (e.g. call options on shares), has financial value, and which is generally lost once the in-house service function is dismantled. Explanation of this argument is provided in Johnstone, D.J. (1997). *Contracting Out and the Price of Burning Bridges* Working Paper, Department of Accounting and Finance, University of Wollongong.

¹⁸ A 'cost object' is an accounting term for the 'object' (i.e. entity) being costed, which might be a particular service function, a product, or a program. Costs which are direct to one cost object are typically indirect to others. For example, the wages of a maintenance person are a direct cost of the maintenance activity or program, but are an indirect cost of other activities to which the maintenance team provides its support services.

Because indirect costs are by nature incurred for the purposes of more than one activity centre, a substantial fraction of activities may need to be outsourced before any significant saving can be achieved. To avoid certain overhead costs, there would need to be a reduction in the scale of the organisation, rather than just changes at the margin. In the limit, the whole organisation would have to be 'contracted out' before the highest order overheads, such as executive salaries, could be entirely avoided.

**Consideration
of relevant
benefits and
issues**

Rather than a significant reduction in overheads, an important potential benefit of marginal changes to the activities of an organisation is the avoidance or postponement of the 'steps' in 'fixed overheads', such as property rents and capital equipment purchases. Outsourcing just a few of the activities of an organisation may not reduce current office rental costs, but may free up sufficient space to put off the time when another building or office suite has to be rented. Where realistic, cost projections on which PVs are calculated must build in considerations of this kind.

It may be that until certain commitments have expired and are up for re-negotiation, outsourcing is not financially viable. For example, imagine an in-house activity that uses a leased computer, where the lease has several years to expire. If the activity is contracted out immediately, the organisation will in effect be paying for two computer systems, assuming that the contractor's price includes at least some component towards its computer equipment cost. Example figures will clarify this problem. Suppose that the lease cost is \$500 per month and other direct costs (e.g. software maintenance) amount to \$200 per month¹⁹. Against this, the contract price for the same service is \$600 per month. If the activity was contracted out now, the organisation would have to pay \$600 to the contractor and \$500 to the lessor, totaling \$1100 per month. The \$200 maintenance cost is avoidable. Costs would thus increase by \$400 per month (\$1100 less \$700) and, therefore, outsourcing would not be viable on cost grounds.

Things change, however, when the current lease expires, because then the choice is between taking out a new lease and paying a total of \$700 per month for the in-house service, as compared with \$600 per month for the external bid (assuming all figures stay the same). At this point it would be better to outsource by \$100 per month.

**Treatment of
depreciation**

In PV analyses, expenditures on capital equipment should be treated no differently than any other cash outflows. That is, the amounts of cash spent and the timing of the outlays should be shown on cost projections (time lines) exactly as and when they are expected to occur. This implies a 'cash' rather than 'accrual' approach, in that in an accrual system the initial expenditure is usually 'capitalised' before being expensed (depreciated) bit by bit over the useful life of the asset according to some conventional pattern (e.g. straight line). For the purposes of capital budgeting decisions, including competitive tendering, depreciation expenses are of no relevance. These are a stylised version of the facts, the facts being simply the amount of cash spent on the asset and when that occurred. Depreciation expenses, unlike most other expenses, do not indicate cash flows.

¹⁹ Assume all indirect costs (e.g. salaries) are fixed, and hence unaffected by whether payroll is an internal or external activity.

**Avoidable
(marginal)
versus 'full'
costs**

For some purposes (e.g. pricing and benchmarking) it is important to know the 'full' rather than merely marginal cost of products or services. This cost includes not only the direct, avoidable costs of the activity in question, but also an 'appropriate' allocation (portion) of all related indirect or overhead costs. The apportionment of overhead costs across the activities to which these relate is known as cost allocation. Activity or product costs which include such allocations are called 'absorption' or 'full' costs. By comparison, the marginal, or avoidable, cost of an activity is just that part of its cost which would be avoided if it was dispensed with. For example, the 'full' cost of the in-house cleaning activity would include a share of overhead costs such as management salaries, rent, personnel costs etc. The marginal or avoidable cost of the cleaning activity includes only that part of such costs which would be avoided upon contracting this activity out. In some circumstances, where there are large fixed overhead costs which are either 'sunk' (e.g. the capital cost of equipment or property already purchased) or which cannot be avoided in the short term (e.g. the cost of equipment or property being leased), there is likely to be a large difference between these two cost measures. If a large part of the 'full' cost of an activity is an allocation of overheads which cannot possibly be avoided, then the savings available in the short-term through outsourcing may not be significant.

**Use of 'full'
costs**

Although 'full' costing has its purposes²⁰, these do not include costing for capital budgeting. The literature is consistent in the view that when using PV techniques to make decisions the projections required are those of actual cash flows or, more particularly, the differences between cash flows across the alternatives under consideration. To include 'full' costs in PV calculations as if they represented actual cash flows is a mistake. For example, suppose that the 'full' cost of an activity is measured at say \$100 per unit, but of this 50% is an allocation of the depreciation expense on plant and equipment (the price of which is already paid and irrecoverable). If this activity was stopped, there would not be a reduction in cash outflows of \$100 per unit of activity, since at least half the \$100 cost is not a cash flow. To build into a PV analysis cost savings of \$100 per unit would not be realistic, and would bring about false expectations of at least the short-term benefits of outsourcing.

The proper (realistic) treatment of capital equipment costs in a PV analysis is simply to plot future cash flows as and when they are expected to occur. If equipment has recently been renewed, there may be no projected capital costs for some time to come. This would tend to favour in the short term insourcing over outsourcing. The benefits of outsourcing may include the avoidance of equipment renewals in the future, in which case this saving would appear at that point in the cash flow projections on which a PV comparison is made.

²⁰ For example, it is widely suggested that overhead allocation can assist cost control. If each agency is allocated a share of the costs of a support function (e.g. personnel), particularly if this allocation is based closely on the demands which the agency places on that support group, then the agency management will be motivated to use that support function economically, and also to discourage it from adding unnecessarily to its own costs.

Activity based costing [ABC] and capital budgeting

Given of the prominence of ABC applications in the public sector, it is important to understand that for the purposes of comparing an in-house bid with external bids, ABC costs are inappropriate²¹. ABC is an elaborate form of full (absorption) costing. Its primary advantage over traditional full costing is that it allocates overhead costs to activities and products in relation to the loads those activities place on the overhead functions of the organisation.

Decision Rule: Use PV of net avoidable costs in comparing in-house and external providers

However, ABC can be used for benchmarking purposes where the in-house costs are being compared against an external 'price' that, similarly, is full cost based.

It is sometimes argued that 'in the long run' all overhead costs are 'variable' and avoidable and, therefore, when making decisions in the long term interest of the entity, it is appropriate to use ABC (absorption) cost measures, even if most overheads are currently fixed and unavoidable. This is wrong, both practically and theoretically. A decision based on notional cost measures which is not representative of actual cash outflows is liable to be not only theoretically 'suboptimal' but, more to the point, very costly to the organisation in terms of those actual cash outflows.

It is true that sooner or later even 'fixed' costs are avoidable. However, the way to allow for this is not to use ABC or other absorption cost measures in the analysis, but to extend the time horizon of the analysis sufficiently to capture the actual fixed cost savings (cash outflows avoided) which will eventually arise when a given activity is outsourced. If these savings are a long time off, as may be when capital has only recently been renewed, an appropriate cost analysis will recognise this.

Discount rate

The theoretically appropriate discount rate is the opportunity cost of capital. This is the rate which could be earned on capital employed elsewhere within or outside the organisation.

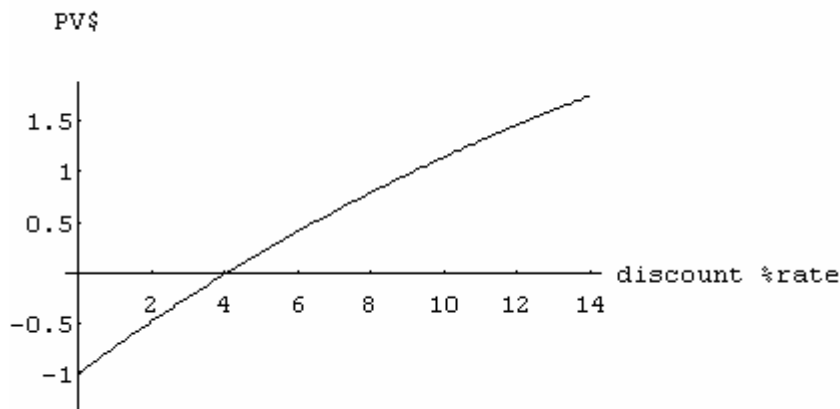
When selecting a discount rate, consistency is vital: if nominal cash flows are used, then the discount rate must be nominal, whereas if the discount rate is real, the cash flows must be real. In general, it is easier to use nominal cash flows and a nominal discount rate.

For NSW Government agencies the appropriate discount rate will be set out in the NSW Treasury's, *Costing Guidelines* when they become available.

²¹ This argument may apply more strongly to ABC than to other more conventional full costs, since ABC applications, at least in the private sector, involve the allocation of overheads previously treated as 'period costs' and hence written off against income in the period of incurrence rather than allocated to activities or products. It is part of the ABC philosophy that 'all costs are product costs', and hence even the highest order overhead costs, such as for example chief executives' and directors' salaries and allowances have in some firms been allocated down to the finished product level.

Sensitivity analyses

When applying PV criteria, it is important to assess the sensitivity of the outcome to the chosen discount rate and to variation in the major cost components. In some circumstances the ranking of alternatives remains the same over a wide class of discount rates. If this class includes all plausible rates (e.g. say 3% to 12% real) then there is little need for debate over which particular rate to apply. This situation occurs in the example above, in which option B (outsource) is preferred for all discount rates greater than 4.08%. The figure below shows the PV of avoidable costs as a function of the discount rate. For rates less than 4.08%, the net PV of outsourcing is negative, but from this indifference point upwards net PV is positive and thus the optimal financial decision is to outsource.



Variations in major cost components should be tested where uncertainty arises as to the future level of those costs. Assessing the sensitivity of the net PV to changes in such costs should be undertaken at a given discount rate. That is, only one variable at a time should be varied to isolate the impact on the outcome resulting from that variable.

Hypothetical case study - accounts payable

The following example is intended to illustrate in a simplified context the costing principles discussed above. Consider the case of a government agency responsible for paying a series of suppliers. There are several private sector entities which could be contracted to perform this service. The question is whether it is in the financial interest of the agency to outsource. Suppose that the best external bid, on cost grounds, for this work is a price of \$875,000 annually. This figure must be compared with the cost of in-house provision, so as to reveal the option with the lowest PV of costs.

Cost factors

If the payment function is contracted out, some costs which are currently incurred by the entity will be avoided. These are as follows:

Direct Costs:

- Salaries plus on costs
- Materials (e.g. cheque payment slips)
- Equipment
- Software
- Software maintenance

Indirect Costs: Computer hardware
Hardware maintenance

Imputed Costs: Taxes

Hardware costs

At present the payment system uses customised software on a networked in-house computer system which serves all the computer processing needs of the organisation. The payments are made at night in what would otherwise be idle computer time. If payment was contracted out, a saving in computer hardware costs would arise only at the time of hardware replacement, when a smaller computer could be run. The computer on which the payment system is processed has only recently been upgraded and refinanced by a four years lease; hence, hardware costs are sunk and cannot be changed until that time. The expected saving in hardware cost at that time is \$300,000. The related saving in annual maintenance costs is expected to be negligible.

Taxes

After calculating the amount of land tax liability, the agency ascertained that imputed taxes were of minor concern. Note that payroll tax is already included in agency budgets and, therefore, is easily identifiable. Income tax need not be imputed (see appendix B).

Software costs

The payment system software is run under license from its supplier at an annual fee of \$180,000. This license extends for five more years. Until that time payments must be continued even if the software is no longer used. As part of the license arrangement, software is maintained by the supplier at an annual cost of \$75,000. This cost does not have to be paid if the software is not used.

Staff costs

Salaries and on-costs of employees responsible for managing and processing the payments can be avoided. These amount to \$525,000 p.a.. Outsourcing would lead to a once only redundancy cost of \$500,000. Other possible direct cost savings (e.g. materials) amount to \$50,000 p.a..

The cost comparison described above can be structured logically as follows.

Annual avoidable 'operating costs' of insourcing:

Salaries plus on costs	525,000
Materials etc. (e.g. cheques)	50,000
Software maintenance	<u>75,000</u>
	\$650,000

Since the annual cost of outsourcing is \$875,000, annual costs would increase by \$875,000-\$650,000 = \$225,000 if the payment system was outsourced.

However, this does not allow for future savings in hardware costs and payment system software license costs. Because these savings are not available for several years, they can only be matched against the \$225,000 increase in annual costs in PV terms. A discount rate of 6% is assumed.

PV of increase in annual costs (in perpetuity)
 $\$225,000/0.06 = \$3,750,000.$

Now, compare this figure with the PV of future savings on hardware and software license costs.

PV of hardware cost savings (taken as arising every four years in perpetuity)
 $\$300,000 / ((1.06)^4 - 1) = \$1,142,957.$

and PV of software license fee savings (annual savings in perpetuity beginning in five years)

$(\$150,000 / 0.06) / (1.06)^4 = \$1,980,234.$

giving a total of \$3,123,191. This is $\$3,750,000 - \$3,123,191 = \$626,809$ less than the PV of the increase in annual 'operating costs' and, therefore, retaining the service in-house is the financially preferable decision even before redundancy costs are considered. If these are brought into the analysis, then the difference between the PVs of the two options is:

$\$626,809 + \$500,000 = \$1,126,809.$

Although this difference seems large, it is not. A PV of \$1,126,809 at a discount rate of 6% amounts to an annual cash flow in perpetuity of only \$67,609 (i.e. $\$1,126,809 \times 0.06$). In other words, a decision to outsource would cost the agency in effect an amount of \$77,997 p.a..

Other factors

When two options are approximately equivalent on financial grounds, the decision can be based on purely strategic considerations. For example, in the example described above, it is likely that as the current software license expires and the time for hardware renewal approaches, the PV calculations will begin to favour outsourcing. With that in mind, it may be decided to make that decision immediately rather than to wait out a period of apparent inaction.

It is important to recognise that the above example shows that while the cost comparisons do not favour outsourcing at present, it is clearly in the agency's interest to outsource in the future when the computer lease expires. The decision to not outsource immediately does not undermine the principle of competitive neutrality, for the decision arises not as a result of the exploitation of government ownership, rather it is a consequence of sensible commercial practice - minimising costs. Ignoring the cost of the lease on the grounds that it is a 'short term' barrier would be foolish.

Time horizons

Note that it is important that where agencies believe that they are currently operating inefficiently and have a clear plan for moving towards more efficient operations, they should use their best estimates of the costs of their future, more efficient operations as the basis on which to compare the two bids. Obviously, to guard against abuse, the expected efficiency improvements should be clear and readily deliverable and subject to independent review. Note also that the above calculations assume perpetuities rather than a finite time horizon. There is a reason for this.

When comparing two cash flow streams, it is technically crucial to allow a sufficient time horizon for completion of the 'natural cycles' in each stream without taking a longer horizon on one than the other. The technical advantage of perpetuities is that their PVs are very easy to calculate - annual cashflow divided by the appropriate discount rate.

The hypothetical case described above is reduced in complexity and detail from most real world problems. It does, however, exemplify the costing principles on which more realistic problems should be solved. In fact its simplicity is only partly contrived. In large part this simplicity is real, since many costs which might superficially be considered attributable to the payment system function and, therefore, in need of inclusion in the analysis, are not relevant because they are not avoidable. For instance, there is no mention above of the rental cost of the office building which houses payment system staff and equipment. This is because it is taken that no part of the rent cost of this building is avoidable. Similarly, there is no allowance for any reduction in management salaries as a result of outsourcing. Again these are treated as unavoidable, as might often be the case.

It is likely that on outsourcing the payment function, those managers who oversaw its operation will not have to do so any more, but instead they will have to manage the payment system contract and the agency's relationship with the contractor. So although some work will disappear, other work will occur and at least partly take its place.

The most difficult aspect of comparing the insourcing and outsourcing options is not that of employing appropriate cost concepts, or of calculating PVs correctly. These are merely technical issues, and once understood are relatively straightforward compared to the problems of projecting the effects which outsourcing will have on future costs. A technically valid analysis is important but cannot make up for unrealistic projections of costs or cost savings.

APPENDIX D PROFORMA FOR COSTING

APPENDIX E

GLOSSARY

Accrual accounting	Under accrual accounting revenues and expenses are recognised when they are incurred or delivered and not when payment is made.
Activity based costing	Activity based costing (ABC) is an elaborate form of full (absorption) costing. Its primary advantage over traditional full costing is that it allocates overhead costs to activities and products in relation to the loads those activities place on the overhead functions of the organisation.
Avoidable cost	The cost which is avoided (not incurred) if an action is not taken.
Benchmark and benchmarking	A benchmark is a performance standard, often established by the performer a particular organisation seeks to emulate. 'Process' benchmarking examines the organisational processes and activities which achieve results. 'Results' benchmarking involves comparing organisational outcomes against a set of performance indicators.
Capital budgeting	The process of allocating capital within an organisation over time.
Capital charge	In the public sector it is a charge levied on the amount of capital employed by an organisation and represents a proxy for the returns normally expected by an investor of capital in a private company. It generally equates to the discount rate.
Cash flow	The flow of money payments to or from an organisation.
Competitive neutrality	The principle that, when an agency compares itself to a private company for the purposes of benchmarking, it should not take advantage of the fact that it is government owned. Thus, for example, in-house bids should be adjusted to include nominal payments of input taxes, including: payroll tax, sales tax, land tax, local government rates and charges, stamp duties, financial institutions duty and relevant excise charges.

Contestable activity	A contestable activity is one which, potentially, can be performed by any of a number of providers. In-house activities which could be performed by contractors are often called contestable activities. This term is not used in this guideline but is often used in the context of market testing.
Depreciation	The amount by which the book value of a tangible fixed asset is deemed to have fallen during a particular accounting period. Therefore depreciation appears as an expense in that period.
Direct costs	Costs that are incurred directly and unambiguously because of a particular activity.
Discount rate	The discount rate compensates for the time value of money. The value of a future stream of benefits (nominated in dollars) depends upon when it is received. The further into the future a given benefit (e.g. sum of money) is received the greater that benefit has to be 'discounted' to give the 'present value' of that benefit. The discount rate is approximated by the interest rate.
Discounted cash flow	Future cash flows from a project (investment) 'discounted' by the discount rate to provide a single value in today's terms.
Evaluation criteria	The evaluation criteria are the factors, such as quality, reliability, experience and price, which are used as an objective basis for comparing competing tenders.
Expression of interest	An expression of interest is usually part of a two stage selection process. It is submitted by a prospective bidder in response to an invitation by a purchaser and sets out the bidder's capabilities and interest in providing whatever the purchaser is seeking. The expressions of interest process is used to assess prospective bidders as a preliminary to issuing invitations to a selected few to submit tenders or proposals.
Fixed cost	Costs that do not change in total despite changes in the cost driver, e.g. production. It should be noted that costs are only 'fixed' for a period of time. In the long run, all costs are variable.

Full cost	This cost includes not only the direct, avoidable costs of the activity in question, but also an 'appropriate' allocation (portion) of all related indirect or overhead costs
Indirect costs	Costs that are incurred in part because of the activity in question yet not in a readily identifiable way e.g. that part of an agency's corporate services attributable to the activity, but not necessarily on a pro-rated basis.
In-house bid	A bid or tender is an offer by a group of employees to provide a service for a price. In these respects it is no different from any tender. If the in-house bid is assessed as offering the best value for money, and is awarded the contract, an agreement, instead of a legal contract, is entered into between the agency and the in-house bidders. The agreement provides for the performance of the work according to the bid and the work specification. The bidders remain employees of the agency.
Invitation for tenders	An invitation for tenders is issued generally through newspaper advertisements, or selectively to chosen providers. The invitation to tender is accompanied by a specification of what the purchaser wishes to obtain, the proposed conditions of contract and the conditions of tendering, and other material as warranted. It is often preceded by an expressions of interest process.
Marginal costs	The cost of the last/next unit of production. It is often used synonymously with incremental and differential costs.
Market testing	<p>Market testing, in a broad sense, means testing the performance of an activity in an organisation against the performance of providers who operate in the commercial market for that activity. In that meaning it can be similar to benchmarking, and can involve obtaining information about the performance of commercial providers through the best available sources.</p> <p>In an often used narrower sense, market testing means inviting competitive tenders, including an in-house bid, in order to allocate the work to the provider who best meets the evaluation criteria.</p>

It is important not to confuse these meanings. Tenders must not be called if the intention is only to establish what the market can offer. Tenders should only be invited if the intention is to award the work to the tenderer who best meets the evaluation criteria.

Net avoidable costs.	Costs which would be avoided if performance of an activity is transferred to an external party
Net present value	The value now of a benefit (expressed as a sum of money) arising on the future. Benefits and costs are 'netted' at the point they are forecast and then 'discounted' back to give a value in today's terms.
Opportunity cost	The income (or cost) that could be earned (or saved) from the next best alternative.
Real rate of return	The rate of interest is made up of two elements. The first is a risk free real rate which generally corresponds to the long term government bond rate. The second represents a risk premium. The sum of the two is the real rate of return, when inflation is added to this the rate is known as the nominal rate of return.
Sensitivity analyses	Analysis that looks at a result as variables material to that result are changed.
Service competition	<p>Service competition refers to the NSW Government policy of harnessing competitive forces, indirectly or directly, to achieve best value for money in the provision of services.</p> <p>Through indirect competition, by way of comparing in-house performance with the best known performance achieved elsewhere, in-house groups are encouraged to achieve equivalent levels of performance or better.</p> <p>Through direct competition, by way of competitive tendering following consideration of all relevant factors, the work is allocated to the tenderer offering the best value for money.</p>
Sunk costs	Past costs that cannot be retrieved no matter what decision is taken.

Tender	A tender is an offer to provide for a price a good or service. A tender is submitted in response to an invitation issued generally or selectively.
Tender specification	A specification is the document which describes what a purchaser wishes to obtain. Preferably to the extent practicable it is expressed in outcome terms so that the means of meeting the purchaser's needs are not unduly restricted.
Time value of money	See 'discount rate'.
Value for money	This is determined by considering all the factors which are relevant to a particular purpose and requires assessment against criteria appropriate to the case in point. Generic criteria are: satisfaction of a genuine need, the quality of the service or product, reliability, the timeliness of service or delivery, the initial and the ongoing costs, and any other criteria relevant to maximising benefits and minimising costs. The highest cost option and the lowest cost option, in different contexts, might each offer the best value for money.
Variable costs	Costs that change in the short term and in response to a cost driver. Therefore, costs are variable when the given cost element varies as production varies, e.g. wages.

APPENDIX F FURTHER ASSISTANCE

Agency contacts

Agency contacts for advice and clarification of relevant issues are listed below.

Service competition policy: contact the Office of the Council on the Cost of Government on (02) 9228 4870.

Employee issues: contact the Public Sector Management Office on (02) 9228 3533.

Requirements of the State Contracts Control Board: contact the NSW Supply Service on (02) 9339 7338 or the Information Technology Service on (02) 9339 7675 (business units of the Department of Public Works and Services).

Expressions of interest, tenders or proposals: contact the NSW Supply Service or the Information Technology Service (see above).

Probity issues: contact the Independent Commission Against Corruption on (02) 9318 5999, or the NSW Supply Service or the Information Technology Service.

Publications

A number of relevant NSW Government and agency publications, with contact details, are listed below.

Consultative Arrangements Policy and Guidelines (1997): contact the Public Sector Management Office on (02) 9228 3576.

Costing Guidelines, forthcoming NSW Treasury publication: contact the NSW Treasury on (02) 9228 4054.

NSW Government publications available from the Government Information Service include the following.

Guidelines for the Engagement and Use of Consultants (1996)

Procurement and Disposal Guidelines (1995) (which will be replaced by forthcoming publications from the Department of Public Works and Services - see below)

Public Sector Management (Goods and Services) Regulation 1995

Service Competition Guidelines (1997)

Publications available from the Department of Public Works and Services, telephone (02) 9372 8240, include the following.

Capital Project Procurement Manual (1993), and other publications relevant to capital projects

A package of documents on procurement policy and processes, under development at the time of publication of this document

Publications available from the Independent Commission Against Corruption, telephone (02) 9318 5999, include the following.

Pitfalls or Probity (1993)

Contracting for Services - The Probity Perspective (1995)

The Practical Guide to Corruption Prevention (1996)

Probity Auditing: When, Why and How (1996)

Direct Negotiations in Procurement and Disposals: Dealing Directly with Proponents (1997)