

Direct negotiations

**Guidelines for
managing risks in
direct negotiations**

MAY 2006



INDEPENDENT
COMMISSION
AGAINST
CORRUPTION

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managing risks in
direct negotiations**

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This publication provides readers with advice, guidance and /or recommendations regarding specific governance issues.

The advice contained herein relates to what the ICAC considers at the time of publication to be best practice in relation to these issues. It does not constitute legal advice and failure to implement the advice, guidance and recommendations contained herein does not constitute corrupt conduct, which is defined in the *Independent Commission Against Corruption Act 1988*.

Public sector organisations are welcome to refer to this publication in their own publications. References to and all quotations from this publication must be fully referenced.

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Commissioner's foreword



Each year, the Independent Commission Against Corruption receives many complaints, allegations and requests for advice in relation to direct negotiations and associated issues. Many of these complaints include allegations of unfair advantage being conferred upon particular proponents, such as leaking confidential information, bias in assessing tenders, mismanaging conflicts of interest and excluding competition by agreeing to direct negotiations.

It is apparent to the Commission that the range of non-traditional forms of procurement, contracting and service delivery has become more widespread across the NSW public sector. This has led to some departures from a traditional 'open competition' approach, and in so doing has created new risks.

Direct negotiations are by their very nature closed processes. They can therefore create opportunities for dishonesty or bias that could amount to corruption. In addition, the absence of competition that is their chief characteristic makes it difficult for an agency to ensure, and prove to the public, that it is obtaining value for money.

Equally important, direct negotiations can often create the perception of conflict of interest or improper conduct.

Because of the risks that accompany the process, agencies should avoid direct negotiations as a general rule. Where they cannot be avoided, agencies should be aware of the risks and actively address them. This publication provides important information and best-practice guidelines to help agencies do that.

Direct Negotiations helps agencies to identify direct negotiation scenarios, to find alternatives to direct negotiations wherever possible and, where direct negotiations are the best or only alternative, to manage them in a manner that is impartial, accountable, transparent and delivers best value for money.

I trust that you will find this a useful resource.

A handwritten signature in black ink, appearing to read "J. Cripps". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

The Hon. Jerrold Cripps QC
Commissioner

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The principal author of this publication is Lewis Rangott, Senior Corruption Prevention Officer, Independent Commission Against Corruption.

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NSW Department of Commerce

(former) NSW Department of Infrastructure, Planning and Natural Resources

NSW Department of Local Government

NSW Ombudsman

NSW Roads and Traffic Authority

NSW Treasury

Glossary

Agency	Any public sector organisation including, but not limited to, departments; statutory authorities; courts, tribunals and commissions; state-owned corporations; public trading enterprises; boards and committees; advisory bodies; trusts; area health services; Aboriginal land councils; universities and local councils.
Direct negotiations	Exclusive negotiations between an agency and a proponent without first undergoing a genuine competitive process. Direct negotiations are sometimes referred to as directly sourced, single-invited or non-competed contracts.
EOI	Expression of Interest
Project	This term is used in this publication to describe any public sector undertaking such as an acquisition, construction of a building, a grant, a sponsorship, a privatisation, etc.
Proponent	A party who is actually or potentially seeking to enter into a transaction or contract with an agency. The term includes, but is not limited to, tenderers, bidders, buyers, sellers, joint venture partners, sponsors, and grant applicants.
RFT	Request for Tender. This is generally any request for a detailed proposal, be it in the form of a tender or some other type of submission, application or bid.

Introduction

Direct negotiations with a single proponent do not necessarily amount to corrupt conduct and, as this publication outlines, there are occasions where direct negotiations are justified. However, the closed nature of direct negotiations can create opportunities for dishonest or partial conduct which could amount to corruption. Quite apart from the risk of corrupt conduct, an absence of competition makes it difficult for an agency to ensure that it is obtaining value for money.

Because of the risks that accompany the process, direct negotiations, as a general rule, should be avoided.

In addition to creating an environment in which actual corrupt conduct might occur, direct negotiations often create perceptions of conflict of interest or improper conduct. The appearance of impropriety can be a consequence of entering into direct negotiation. Even in the absence of any improper motive or conduct, direct negotiations may infer a degree of favouritism, unfairness and secrecy. This can generate real consequences for an agency by damaging its reputation, reducing public confidence and deterring clients, suppliers and stakeholders from interacting with the agency. A perception of dishonesty can also lead to enquiries from agencies such as ICAC and the NSW Ombudsman, as well as from the media.

This publication outlines the risks and pitfalls associated with direct negotiations, as well as the areas where agencies are sometimes trapped into uncompetitive deals. It does not need to be read necessarily from beginning to end. Rather, agencies will find that different sections are relevant to their particular needs.

Chapter 1 describes what direct negotiations are and where they tend to arise. It also provides some basic principles that agencies should consider before entering into direct negotiations.

Chapter 2 outlines a range of areas where direct negotiations may be warranted and justified; gives agencies advice on techniques for avoiding direct negotiations wherever possible, and guidance on how to conduct direct negotiations on projects where direct negotiations can be justified.

Chapter 3 presents a range of risk scenarios where flaws in the contracting process can lead to unjustified direct negotiations or other lapses in probity, plus appropriate remedies.

Shaded boxes throughout give examples, some of which are fictional, to illustrate the point being discussed.

The appendices describe some of the legal obligations that NSW agencies have in relation to direct negotiations and discuss the probity aspects of a relatively new form of project delivery – alliance contracting.

This publication is written for public sector managers and staff who may from time to time find themselves responsible for commercial or contractual interactions with the private sector, the not-for-profit sector or public sector organisations operating in a commercial environment. It will also be useful for elected public officials and members of boards and committees who are responsible for overseeing substantial projects.

It is intended as a guide for agencies attempting to reconcile commercial realities and opportunities with the need to adhere to public sector values such as impartiality, objectivity, transparency and accountability. In recent years, the Commission has had to enquire into or give advice on proposals and commercial arrangements that were not contemplated by the public sector 10 years ago. Because of the considerable change and innovation that characterises government/private sector contracting, this publication cannot foreshadow every variation on the direct negotiations theme. However, the general principles outlined in this publication will be useful and should inform any decision to enter into direct negotiations.

Chapter 1: Understanding direct negotiations

What are direct negotiations?

The term 'direct negotiations' refers to exclusive negotiations between an agency and a proponent without first undergoing a genuine competitive process. Direct negotiations are sometimes referred to as directly sourced, single-invited or non-competed contracts.

Because of the risks that accompany the process, direct negotiations, as a general rule, should be avoided.

When and where might direct negotiations arise?

Because of the risks that accompany the process, direct negotiations, as a general rule, should be avoided

The circumstances in which an agency is required to decide whether direct negotiations can be justified vary widely. An agency may initiate direct negotiations itself, or the idea may come via an unsolicited proposal from the private sector or a third party. Sometimes an agency is forced into direct negotiations because of a lack of viable alternatives, but on other occasions it may consider that direct negotiations can be justified despite the presence of alternatives.

Direct negotiations can also occur in a range of different transactions, from small, verbal agreements to large multi-million dollar written contracts.

Most of the queries and complaints that the Commission receives concerning direct negotiations relate to government procurement. However, there are numerous other areas involving some form of transaction between the public and private sectors where direct negotiations could arise. These include:

Disposal – This can refer to more than just disposal of surplus goods or property. Agencies can also dispose of intangible assets such as leases, airspace, management rights, advertising space, rights to use natural resources (e.g. for fishing or mining) and other types of licences.

Sponsorships – Agencies sometimes approach or are approached by companies or groups seeking to enter into a sponsorship arrangement.

Administration of grants – Many agencies regularly oversee cash or in-kind grants made to the private and not-for-profit sectors.

Joint ventures – Where an agency cannot deliver a project or service with its own resources, it may choose to enter into a joint venture arrangement with another entity. In this situation, the joint venture partner is not working for the agency under a traditional procurement contract as much as it is working with the agency to co-produce an outcome. In some cases a separate entity with a board and shareholders is established to manage the joint venture.

ICAC investigation into Koopahtoo Local Aboriginal Land Council

In 2005, the Commission made findings of corrupt conduct in relation to joint ventures between Koopahtoo Local Aboriginal Land Council (KLALC) and private development companies. These companies approached the KLALC with unsolicited and exploitative proposals to develop KLALC-owned land. Proper market testing of these proposals may have improved the return to the KLALC. The Commission reported:

... even assuming the optimistic selling price contained in the outline feasibility assessment, an assessment done against the terms of the joint venture agreement would have suggested that the additional benefit of the agreement to KLALC (beyond the value of the land) was less than 10% of the value of the land it was contributing. The total value to [the developer], through its management development fee, was close to the value of the land. The question for KLALC should have been, would [the developer] provide value for this return? ¹

Debt and equity – Private financing of public infrastructure and amenities has emerged as an alternative to more traditional forms of procurement. This has led to private sector financiers taking debt and/or equity positions in public projects. Similarly, public sector agencies may in some circumstances invest or lend funds in the private sector.

Bartering arrangements – Agencies sometimes enter into agreements to exchange assets, goods and services in kind, rather than transacting in cash. In this situation suppliers become customers and vice versa.

Seconding staff or resources – Agencies sometimes agree to provide staff or equipment for an external project or purpose.

Business proposals from staff – It is not uncommon for public sector staff to approach management with innovative ideas that may have a commercial or entrepreneurial component (see box overleaf). Proposals of this nature can also include staff or management buy-outs of discrete parts of the agency that may be able to stand alone as private businesses.

¹ Independent Commission Against Corruption, 2005, *Report on investigation into certain transactions of Koopahtoo Local Aboriginal Land Council*, ICAC, Sydney.

Business proposal from a member of staff

A researcher working in a public hospital develops an idea for manufacturing a new instrument for diagnosing a serious illness. The idea has been well researched and has a great deal of merit. The researcher proposes that she be allowed to commercialise the idea by establishing a separate, private company.

In formulating a response to the researcher's request, management needs to consider a range of issues. Certainly the researcher deserves credit for her idea, especially since it has the potential to assist patients and create efficiencies. However, because the researcher developed the idea as part of her role as a public official and used public resources to do so, any intellectual property flowing from the idea rightly belongs to the public agency.²

The hospital or area health service should develop a separate business case for the commercialisation proposal. This may include an in-house proposal but should involve options for inviting expressions of interest from other sources that may be able to commercialise the idea.

First principles

Given the complex nature of the interface between the public and private sectors, this publication cannot address every possible scenario where direct negotiations could occur. Consequently, agencies should consider the principles outlined below when deciding whether to enter into direct negotiations.³ These fundamental principles of public sector work are potentially jeopardised when direct negotiations are used. If a proposal to enter into direct negotiations violates any of these principles, alternative courses of action should be considered or risk mitigation strategies employed, such as those described in Chapter 2.

Obtaining best value for money

Obtaining best value for public money is a fundamental principle of public sector work. When it is known that there are other proponents who could feasibly compete for a contract, agreeing to direct negotiations with a single proponent increases the risk that the agency may not obtain best value for money. When a proponent does not have to compete for contracts there is a higher risk that the proponent may unjustifiably increase profit margins, exaggerate expenses or otherwise boost returns on the contract.

Furthermore, when an agency restricts the number of parties with which it does business, it also limits the number of potentially useful ideas, solutions and options that it has access to.

² The *Intellectual Property Management Framework for the NSW Public Sector* (NSW Premier's Department, February 2005) states: "By law, the State of NSW owns any IP developed by its employees in the course of their employment unless it is specifically agreed otherwise. Moral rights are an exception; they automatically belong to the creator in the absence of an agreement to the contrary." (p. 12).

³ For matters involving procurement, most agencies are governed by the NSW Code of Practice for Procurement. Part 4 of the Code outlines the required standards of behaviour.

Providing a fair chance to do business with government

Doing business with government is a key driver of economic activity and many private firms and not-for-profit organisations rely on access to government contracts in order to stay in business. Direct negotiations can unfairly exclude capable firms that employ staff, pay taxes and contribute to the economy.

Demonstrating accountability and transparency

Accountability and transparency are related concepts. Accountability involves agencies being able to demonstrate and justify to an appropriate authority how public resources are used. This involves allocating and taking responsibility for past and expected future performance. This necessarily involves keeping good records that leave an audit trail.

Transparency means an agency must be prepared to open a project and its processes to scrutiny and possible criticism. This also involves providing reasons for all decisions that are taken and providing appropriate information to relevant stakeholders.

Demonstrating accountability and transparency gives proponents and taxpayers additional confidence in the decisions being made, and also reduces the opportunities for corrupt conduct and fraud.

The selective and closed nature of direct negotiations can create suspicions of favouritism and bias, consequently making it difficult for public agencies to justify the decisions they make. Exclusive negotiations that are underpinned by commercial-in-confidence provisions are more vulnerable still to perceptions of a lack of accountability and transparency.

Dealing with conflicts of interest ⁴

Direct negotiations (or the possibility of direct negotiations) can create an environment where private interests could influence or be seen to influence the outcome of the contract. In contrast, an open, competitive selection process, with a predetermined business plan and selection criteria and an accompanying audit trail, make it difficult for private interests to influence, or be seen to influence, the outcome of a contract.

⁴ More specific information about identifying and managing conflicts of interest is available in Independent Commission Against Corruption and Crime and Misconduct Commission, 2004, *Managing Conflicts of Interest in the Public Sector Toolkit*, ICAC/CMC, Sydney & Brisbane. Available at <http://www.icac.nsw.gov.au>.

Chapter 2: Guidelines for managing the direct negotiation process

Deciding whether to undertake direct negotiations

As a general rule, direct negotiations should be avoided. However, there are scenarios where it may be impossible to test the market or to use a competitive process. In other cases, a competitive process may be possible but for various reasons may be so impractical or expensive that direct negotiations are the most acceptable way to fulfil a contract. In these cases, direct negotiations can be justified.

The Commission has identified a number of circumstances (listed on pages 14–21) where direct negotiations *may* be appropriate. Agencies should, however, use these only as a guide to decision making and should always bear in mind that, just because these circumstances apply, direct negotiations may still not be the way to proceed. Agencies can often avoid direct negotiations, simply by opening up the process to some degree of competition.

Agencies should also ensure that they fully examine claims that direct negotiations are the most suitable course of action and that they explore any alternative courses of action. In addition to the following, agencies should also rely on common sense and the general principles outlined in “First principles” in Chapter 1 to guide their decisions.

Exemption by statute or government policy

There are areas where direct negotiations are either permitted or required by statute or government policy.

In New South Wales, agencies subject to the *Public Sector Employment and Management Act 2002* are required to purchase goods and services, where available, from panels of standing offer contractors maintained by the State Contracts Control Board (operating within the Department of Commerce).⁵ Suppliers on these panels have already been through a competitive process and have been pre-qualified by the Board. While agencies subject to the Act are required to deal directly with suppliers on these panels, the Commission suggests that, wherever possible, your agency seeks a number of quotations from empanelled suppliers as a matter of course.

Similarly, although local councils are not required to tender for contracts valued at less than \$150,000, it is usually both prudent and cost-effective to seek multiple bids for all but the most minor acquisitions.⁶

⁵ Clause 16(3) of the Public Sector Management (Goods and Services) Regulation 2000 states: “If a period contract is arranged by the [State Contracts Control] Board, Departments must use that contract for obtaining goods and services to which it applies.”

⁶ See section 55(3) of the *Local Government Act 1993* for details of other exemptions from the requirement to tender. Local government public–private partnerships are covered by sections 400B–400N of the Act.

In the area of privately financed projects, most agencies are bound by the procedure for direct negotiations set out in *Working With Government – Guidelines for Privately Financed Projects* (NSW Government, November 2001).

In addition, government policies in areas such as industry development, science and research, defence, foreign affairs, Aboriginal affairs and so on may encourage agencies to contract with certain private sector entities, or to avoid others. Restricted competition and possibly direct negotiations are unavoidable in these cases.

Examples of NSW Government policy relating to contracting

- In some cases it is government policy to dispose of land directly to another public sector agency. Agencies should consult NSW *Treasury Circular 04/09* (August 2004) and the NSW Treasury publication *Total Asset Management Manual – Asset Disposal Strategic Plan* (September 2004) for guidelines on the disposal of real property assets and disposal by private treaty.
- Where applicable, agencies should consult *Premier’s Memorandum 2002-09* in relation to the leasing of office space. Agencies are required to enlist the assistance of either the Government Leasing Service or the Crown Property Portfolio when entering into negotiations for new or renewed leases.
- It is government policy to give preference to the use of government-owned training and conference facilities when conducting workshops, meetings and forums. Agencies should consult *Premier’s Circular 2000-32* for more details.
- Public sector agencies requiring the construction and maintenance of roads are permitted to enter into direct negotiations with the NSW Roads and Traffic Authority. See *Premier’s Circular 2003-24*.
- The Crown Solicitor must be engaged by government agencies to perform core legal services in relation to matters that have implications for government beyond an individual minister’s portfolio; involve the constitutional powers and privileges of the state and/or the Commonwealth; raise issues that are fundamental to the responsibilities of government, or relate to matters falling within the Attorney-General’s area of responsibility.⁷

Monopolies

When it is beyond doubt that there is only one proponent that can meet an agency’s well-defined needs (and recent market testing supports the conclusion), direct negotiations can be justified. Where there is any doubt, or the agency has assumed rather than demonstrated that there is no competition, it should test the market.⁸

Agencies need to verify the existence of a monopoly market with a substantial fact-finding process. For obvious reasons, an agency should never rely on claims by a proponent that it is the only provider in the market.

In rural and regional areas agencies commonly have access to only a limited number of potential suppliers or contractors. On the basis that there may be only one available provider, direct negotiations may be difficult to avoid.

⁷ See the Crown Solicitor’s website www.cso.nsw.gov.au.

⁸ A market that has only a small number of competitors is called an oligopoly. Some of the risks associated with dealing with oligopolies are discussed on p. 35.

Intellectual property rights

Intellectual property (IP) is defined as:

*Inventions, original designs and practical applications of good ideas protected by statute law through copyright, patents, registered designs, circuit layout rights and trademarks; also trade secrets, proprietary know-how and other confidential information protected against unlawful disclosure by common law and through contractual obligations, such as confidentiality agreements.*⁹

Where IP forms a necessary part of a project and ownership of that IP can be demonstrated, agencies may have to agree to direct negotiations, perhaps by purchasing or licensing the IP. At the same time, an agency's legal adviser should verify any assertions that proponents may make about their IP rights. An innovative proposal, of itself, may not necessarily contain actual or potential IP.

However, regardless of whether a proponent claims IP ownership, if the proposal is innovative or of value to the agency, and it is unlikely that another proponent or the agency itself would have come up with the idea independently, it would be unethical to use the idea without compensating the proponent.¹⁰ To be considered confidential, ideas must not yet be in the public domain. Similarly, a collection of ideas, each of which is individually common knowledge but jointly may not be, may also be entitled to confidential status.¹¹

A proponent that claims ownership of significant IP might, as a precondition to providing an agency with details of its proposal, ask the agency to sign a confidentiality agreement. Agencies should take great care to ensure that the wording of such an agreement does not confer on the proponent exclusive rights (such as a right to direct negotiation) in the event that they decide to proceed with the project. They should also obtain legal advice.

An agreement by an agency to protect asserted IP and other asserted confidential information should be sufficient to satisfy a proponent's confidentiality requirements without restricting the agency's future options. Expert legal advice should be sought if a proponent insists on any further undertakings or if there are any other doubts about a proposed agreement.

⁹ NSW Government 2001, *Working with Government – Guidelines for Privately Financed Projects*, NSW Government, Sydney, p. 53.

¹⁰ For instance, in the European Union, member states have used the option of compensating the initiator of a project by making a payment outside of the subsequent call for competitive bids. Commission of the European Communities 2004, *Green Paper on Public–Private Partnerships and Community Law on Public Contracts and Concessions*, European Commission, <http://www.europa.eu.int/>.

¹¹ NSW Treasury 2005, *Intellectual Property Guidelines for Unsolicited Private Sector Proposals submitted under Working With Government*, NSW Treasury, Sydney, <http://www.treasury.nsw.gov.au/wwg/intellectual.htm>. Last updated 14 November 2005.

Dealing with “unique” proposals

It is common for unsolicited proposals to contain claims about originality or uniqueness. Proponents sometimes also assert ownership of IP relating to the idea. Sometimes these claims are legitimate but in others they are overstated and are designed to avoid competition. Intellectual property law is a constantly changing field, so where agencies are in doubt as to the existence of IP, they should seek specialised legal advice.¹²

Unsolicited proposals can, however, generate innovative designs and suggestions that would be in the public interest to adopt. Agencies should therefore be mindful of these potential benefits and the need to encourage such proposals where appropriate. However, it is useful to bear in mind that the person who originates a good idea is not necessarily the best person to implement it.

Just like physical property, IP can be bought and sold. Therefore, if a proponent owns bona fide IP, it can be separately acquired. This may allow the agency to use the property while still exposing other aspects of the project to competition.

The NSW Government’s guidelines for privately financed projects state:

*Bidders must identify the elements of their bids claimed as intellectual property. Government may seek to negotiate the purchase of intellectual property forming part of an unsuccessful bid.*¹³

Agencies should ensure that ideas of unsuccessful bidders not already in the public domain are protected, even where the proponent has not specifically asserted ownership of IP.

Real property rights

If a particular proponent owns a parcel of real property that is on or near the site of a proposed project, direct negotiations may be justified on the basis that the land is unique and necessary to the project. Real property includes not only land, but also airspace, long-term leases, mining rights, easements and other rights over land. In some cases, it may be practical for an agency to purchase or compulsorily acquire the property,¹⁴ but these processes can be time-consuming and expensive.

Before agreeing to direct negotiations, the agency should ensure that the “unique” solution offered by a proponent by virtue of its real (or intellectual) property is the only, or clearly the best, solution to the agency’s requirements. Even if a proponent claims an apparent unique ability to deliver a particular project, the agency can keep competition open and transparent by seeking expressions of interest in outcome-based terms.

For example, rather than asking proponents to design a new bus, the agency could express its requirements in terms of guaranteeing ease of transport between points A, B and C for 10,000 people a day. This opens up the scope of the project to its desired end result.

¹² For more information on intellectual property, see NSW Premier’s Department 2005, *Intellectual Property Management Framework for the NSW Public Sector* or <http://www.ipaustralia.gov.au>.

¹³ NSW Government 2001, *Working with Government – Guidelines for Privately Financed Projects*, NSW Government, Sydney, p. 26.

¹⁴ Pursuant to the *Land Acquisition (Just Terms Compensation) Act 1991*.

Joint ventures and relationship contracting

Rather than enter into a principal/agent relationship with a contractor, agencies sometimes create joint venture relationships. Selecting a joint venture partner should be a competitive process. However, the venture itself, once established, will probably entail direct negotiations between partners for the sourcing of goods and services and other transactions that fall within the scope of the joint venture. This can be justified provided the parties anticipate this during the original selection process.¹⁵

The Commission advises that prior to conducting the process of finding a joint venture partner, agencies should complete a separate business case for the project. If the business case is not prepared until after the joint venture has been formed, the agency may be locked in to an undesirable relationship or be otherwise handicapped in its ability to pursue its preferred course of action.

Complete a separate business case for the project prior to finding a partner

Agencies should avoid allowing a joint venture to creep into areas of service delivery that are beyond the scope of any original agreement. Where possible, such relationships should also have an agreed end-point at which the project objectives are achieved and the relationship is dissolved. In addition, where a current or former joint venture partner bids for another contract, the agency concerned should ensure that it does not obtain an unfair advantage.

Joint ventures form part of a wider, non-traditional approach to contracting which involves establishing a close and/or long-term relationship with a particular contractor or project partner. This is variously known as relationship contracting, partnering and/or strategic alliancing.

This form of contracting entails a departure from the conventional principal/agent model of engaging with the private sector and relies more on a collaborative approach to service delivery based on mutual trust. This method of project delivery focuses on adopting a non-adversarial, best-for-project approach that attempts to shape behaviour without relying on enforcement via the terms and conditions of a legal contract.¹⁶

These types of business relationships often make sense in situations where the agency wishes to enter into a long-term relationship with a contractor. As with joint ventures, it may be appropriate to engage in direct negotiations within a relationship contract, provided it is anticipated during the original selection process, as described below:

Joint venture case study 1

Many government agencies contract with private sector organisations for the provision of community and social services, such as aged care. These services typically need to be provided with a degree of continuity in order to meet the needs of clients. For instance, it would be impractical to force residents of a publicly funded aged-care facility to relocate each time a different contractor wins a tender.

In cases like this, a form of relationship contracting is appropriate, which gives the incumbent service provider a right to have its contract renewed provided it meets with mandated quality standards. The service provider's original contract should be based on a competitive process, but should anticipate an ongoing period of service provision. The service provider's right to ongoing funding should be contingent on demonstrating value for money and accountability for the use of public funds.

¹⁵ For local councils, certain types of joint venture are governed by sections 400B–400N of the *Local Government Act 1993*.

¹⁶ Alliance contracting, discussed in Appendix 2, is a form of relationship contracting.

Joint venture case study 2

The Commission received a complaint that an agency was bypassing the normal competitive process by awarding multiple contracts to a particular consultant with which it had a pre-existing joint venture agreement to market government services. The Commission conducted enquiries that revealed that some of the contracts being awarded to the consultant, while related to the consultant's field of expertise, were not within the scope of the joint venture agreement. The agency argued that because the consultant had already been through a competitive process when being selected as a joint venture partner, it could be awarded related marketing contracts via direct negotiation.

The Commission disagreed and advised the agency that it should allow the consultant to perform only the work specified in the joint venture agreement. The Commission advised that in this case any other work should be awarded via the normal competitive process of multiple bids.

Interface with an existing facility or product

On occasions, a public project or acquisition needs to interface with an existing piece of equipment, technology or facility. Acquisitions of replacement parts, minor extensions, continuing services for existing equipment and minor software upgrades may not be amenable to a competitive process. Where a change of supplier would *compel* the agency to procure works or services that do not meet requirements of interchangeability or inter-operability, it would be reasonable for the agency to (re)engage an incumbent or experienced provider via direct negotiation.

The need for a project to interface with an existing facility should not, however, give a proponent an automatic right to direct negotiation. The agency should assess whether alternative contractors could potentially undertake the work at a competitive price. Agencies should be cautious about misusing the interface criterion either as a basis for agreeing to direct negotiations at the behest of an incumbent or to avoid the short-term time and expense associated with the competitive process. In addition, agencies should try to avoid acquiring technologies that confer bargaining advantages on certain proponents.

Interface with existing facility case study 1

An energy company needs to add 20 per cent of additional capacity to one of its power plants in order to service its growing market. The existing plant uses a complex technology that was installed by a supplier that won a competitive tender process several years previously.

This supplier is familiar with the layout and operation of the existing plant and is best placed to ensure continuity of operation while the additional capacity is added. Because the new project needs to interface with the existing plant, it would be more practical and cost-effective to use the technology already in place.

A market analysis determines that no alternative supplier could realistically add the required capacity.

Consequently, direct negotiations with the incumbent technology supplier can be justified.

Interface with existing facility case study 2

A hospital uses a particular brand of x-ray equipment in its radiology department. Due to expanding demand for its services, the hospital successfully obtains funding to have the radiology department fitted out with additional equipment. The manufacturer of the existing x-ray equipment approaches hospital management suggesting that it be awarded the contract to supply and install new equipment by direct negotiation, arguing that its brand already interfaces with the hospital's patient record systems and that all the staff are trained in how to use the equipment.

The hospital's procurement manager is sceptical of the manufacturer's claims that its brand is the only one that can interface successfully with the hospital's systems and decides to conduct an EOI process. The responses to the EOI reveal that most types of x-ray equipment can be integrated with the hospital's existing systems and that the radiology staff can be easily trained in the use of alternative types of equipment. Consequently, the procurement manager proceeds with an RFT process which results in an advantageous bid from an alternative supplier that is accepted by the hospital. Direct negotiations would not have been justified in this case.

Sponsorships

From time to time, agencies are approached by companies wishing to enter into an agreement to sponsor the agency or one of its activities. Companies often make these approaches on the basis that the agency will receive a benefit without having to incur a cost. This is not strictly true; in cases where an agency accepts a sponsorship, it is allowing the sponsor to associate and identify with the reputation and values of that agency. This is valuable to the sponsoring organisation and, if not carried out correctly, the sponsorship arrangement can involve risks and potential costs to the agency being sponsored.

Unsolicited sponsorship offers are seldom amenable to market testing. For this reason, the Commission recommends that all agencies disseminate sponsorship opportunities widely, for example by outlining these opportunities on their website. Only when the agency has publicised these general sponsorship opportunities and has established its criteria for accepting sponsorship, may direct negotiations with potential sponsors be appropriate.¹⁷

It is also important to make sponsoring organisations aware that sponsoring or contributing to a benevolent cause will in no way open doors for them to benefits such as access to government contracts via direct negotiations. In fact, agencies should try to avoid accepting sponsorship from parties that are also suppliers.

¹⁷ For more detail about managing sponsorships, refer to Independent Commission Against Corruption, *Sponsorship and the public sector: A guide to developing policies and procedures*, ICAC, Sydney. Forthcoming.

Similarly, if an agency wishes to become a sponsor or is approached by a party seeking sponsorship, it should satisfy itself that it is obtaining value for money and that other, more advantageous, alternatives to sponsorship do not exist.

Emergency circumstances

In situations where a delay would threaten public health and safety, damage the environment or create a serious legal or financial risk to the agency or the government, direct negotiations may be warranted. Poor planning or looming management deadlines do not constitute emergency circumstances.

Section 55(3) of the *Local Government Act 1993* also allows tendering requirements to be bypassed in the case of an emergency, extenuating circumstances, remoteness of locality or the unavailability of competitive or reliable tenders. These exemptions from tendering requirements may justify direct negotiations.¹⁸

Other circumstances

In addition to the above circumstances, the following may warrant or justify direct negotiations:

- where the proponent has a **legal right** to direct negotiation. For instance, a contract (such as a lease) may provide for a right of renewal provided certain criteria are met.
- when the **value of the contract or transaction is very low** relative to the cost of conducting a competitive process.¹⁹ Where practical, contracts of this nature should be made with a pre-qualified or period contractor. Minor variations to an existing contract may also fall into this category.
- when a **competitive process has failed to produce an advantageous or satisfactory offer** and the agency does not expect a repeat of the process to produce a better result. In such circumstances the agency may choose to negotiate directly with the 'least unsatisfactory' of the available proponents, or another proponent that has expressed a genuine interest.²⁰

If the agency failed initially to obtain a satisfactory offer because of an error or oversight on its part, direct negotiations are not appropriate. In addition, agencies should not coerce unsuccessful proponents into lowering prices, nor should they engage in bid-shopping, that is trading off the prices of one proponent against another. Ideally, the initial competitive process should articulate the right of the agency to enter into direct negotiations in the absence of an advantageous or satisfactory offer.

- when it is necessary to **maintain a temporary source of supply** while a competitive bidding process is still being finalised. The temporary appointment of a supplier via direct negotiations is preferable to rushing the bidding process or automatically renewing the incumbent's contract for a lengthy period of time.

¹⁸ The Commission notes that an exemption from tendering requirements does not necessarily mean that the competitive process has to be abandoned altogether.

¹⁹ See Appendix 1 for information about State Contracts Control Board delegations that relate to the acquisition and disposal of low-value items.

²⁰ Because negotiations in these circumstances follow a competitive (albeit unsuccessful) process, they do not technically meet the definition of direct negotiations outlined in Chapter 1. That notwithstanding, agencies can follow this process provided the original competitive process was genuine.

Avoiding the need for direct negotiations: pitfalls and remedies

Debate about direct negotiations is often couched in terms of diametric opposites: open competition versus direct negotiations. However, there is a range of options that lie in between. While there are occasions where full and open competition may not be practical, there are often viable alternatives to negotiations with a single proponent.

There are often viable alternatives to negotiations with a single proponent

The Commission encourages agencies to consider variations on the theme of open competition before deciding on direct negotiations as a course of action. While planning the business case of a project, agencies should consider the possibility of an uncompetitive marketplace. In other words, before formally seeking expressions of interest, an agency should have a reasonable idea of whether there will be two or 200 interested parties, and should frame its needs accordingly. Where necessary, and if possible, the agency should take steps to improve the level of private sector interest.

Lock-in

In some situations, agencies need to remember that even where they do follow a competitive process, they may find that once they have selected their preferred option, it can subsequently be very costly to switch to an alternative. This can lock an agency in to future direct negotiations with an incumbent supplier (see case studies of interface with existing facility on pages 19–20).

For this reason, agencies should always factor the whole-of-life costs of a particular course of action, including transaction and exit costs, into their planning. One of the first things to be addressed in a contract, for example, should be how to end or renew that contract.

If agencies are purchasing intellectual property (IP) from a private sector proponent, they should remember that their right to use that property may not be unlimited. If the right to use IP has not been purchased outright the agency may be locked in to costly negotiations with the IP owner.

‘Buy Not Build’²¹

It is government policy to purchase off-the-shelf information technology applications wherever feasible, rather than build tailored solutions.

This is partly in recognition of the direct negotiations risks posed by acquiring a unique technology that can be supplied, serviced and maintained only by a narrow range of suppliers.

In this context it is worth noting that about 70 per cent of total information technology life-cycle costs can be incurred after implementation.

As the following example shows, outsourcing functions that have historically been performed internally can lock an agency into a situation in which the function cannot easily be brought back in-house.

²¹ NSW Office of Information and Communications Technology 1997, ‘Buy Not Build’, *IM&T Blueprint Memorandum 8.1, version 2, NSW Office of ICT, Sydney*.

An example of lock-in

An agency chooses to outsource its call centre division of 15 staff to the private sector. Following a competitive tender, XYZ P/L wins the contract. XYZ records and maintains all of the agency's information about its customers' orders, payments, contact details and complaints.

When XYZ's contract expires three years later, the agency discovers that all of the internal expertise it once had has disappeared and it no longer has even the physical space for another 15 staff. In addition, because the agency's computer systems, records management and billing arrangements now interface with XYZ, it estimates that just to transfer to a competitor would cost at least \$200,000.

XYZ is aware of its advantage and can, therefore, add up to \$200,000 to the cost of its new bid and still be confident of retaining the contract. The agency is in a situation where it has little choice but to enter into direct negotiations with XYZ, which in turn may reduce or eliminate the benefits obtained from the original decision to outsource.

Preventative strategies for agencies in situations like this one include:

- requiring the contractor to use technologies and methods that can be integrated with the agency's own systems and/or transferred to other providers;
- incorporating options in the original contract that govern the terms and conditions of renewal;
- inserting obligations into the original contract that require an unsuccessful incumbent to absorb future transaction and transition costs;
- incorporating a clause in the original contract that allows the agency to own such physical and intellectual property as it requires to allow for a competitive process; and
- retaining the ability to restore in-house functionality.

Bundling and unbundling contracts

If it becomes apparent that only a narrow range of suppliers exists for a particular product, agencies should consider revising the scope of their RFT/EOI in order to attract additional interest.

One way of doing this is to bundle items together to create a larger contract. For example, an agency purchasing a single item of office equipment may attract only a few standard quotations at retail prices, whereas a contract to provide and maintain an entire suite of equipment may attract more bids at better prices. Conversely, disposing of a wide range of surplus items at a single yearly auction may generate more interest than one-off sales as the need arises.

Agencies that are located in remote areas may find that bundling contracts is a good way of avoiding direct negotiations. In addition, by combining the purchasing power of public agencies, for instance via a Regional Organisation of Councils, it may be possible to create economies of scale that obviate the need for direct negotiations.

In some cases, *unbundling* contracts can generate additional bids from smaller proponents. For instance, an agency administering grant money to charitable

organisations may find that the funds are best used by providing a combination of small and large grants based on the size and speciality of the recipient organisations. Larger grants, while potentially easier to administer, may deter small but nonetheless efficient charitable organisations from applying for funding.²²

Consider bidding costs

If the bidding costs for a particular project are high relative to the total value of the contract, then it may be difficult to generate private sector interest. The NSW Treasury states that agencies should select a tender method that “avoids creating unnecessary costs for tenderers”.²³

Where an agency considers that additional competition and overall value for money can be achieved, it should explore the lawful opportunities for lowering the costs of bidding. This may include reducing the number of stages or iterations, reducing the amount of detail required in responses to EOI or RFT documents, or even reimbursing proponents’ reasonable bidding costs.²⁴

In an industry that is experiencing a boom or high demand, it is conceivable that private firms will not bid for public sector work or will only bid at inflated prices. This may lead to a situation of de facto direct negotiations, whereby just one complying or attractive proposal is lodged. High bidding costs can be a particular disincentive to small and medium-sized enterprises that do not have staff dedicated to preparing tender responses.

Where applicable, agencies should establish standing offer or period contracts for pre-qualified contractors using a competitive process. Such contractors can then be engaged to perform regular work required by the agency, without having to repeat a tender evaluation or similar process.

Develop alternative sources

In areas where there is a private sector monopolist or a lack of competition, agencies may be able to facilitate an in-house bid or some other form of internal provision. The competitive tension provided by an in-house bid may create savings even where the bid itself is unsuccessful. That is, the very presence of an in-house competitor may oblige a monopolist to lower its prices in order to retain the contract.

In situations where there is a shortage of available contractors, agencies may be able to encourage a provider in a related field to expand its operations. For instance, in some regional areas there may be a shortage of contractors who can repair computer equipment quickly. However, a local provider of new computer equipment may find it worthwhile to expand into repair work if it is known that a demand exists.

Finally, if there is only one supplier in the market capable of providing a complying or attractive tender, the agency should use the process of debriefing unsuccessful tenderers as a means of generating more attractive bids in the future.

Postpone or cancel the project

Agencies should preserve the option of not proceeding with a project if direct negotiations cannot be avoided or if the project cannot be undertaken on terms that are acceptable to the agency.

²² Contracts should never be ‘unbundled’ for the purpose of keeping the size of the contract below competition thresholds or to avoid the scrutiny of higher tiers of management.

²³ NSW Treasury 2005, *Code of Practice for Procurement*, NSW Treasury, Sydney.

²⁴ The NSW Government’s *Working With Government Guidelines* state that reasonable bidding costs may be reimbursed if a decision is made to terminate a call for detailed proposals for reasons other than value for money, commercial or technical reasons (November 2001, p. 27).

Chapter 3: How to undertake direct negotiations

If, after having considered the general principles in Chapter 1 and the circumstances outlined in Chapter 2, an agency decides to negotiate directly with a proponent, there are some steps it should take to ensure that the process is both resistant to corrupt conduct and delivers value for money.

The Commission urges agencies to consider the risk mitigation measures they can take in each of the following processes:

- making the decision
- identifying and managing conflicts of interest
- obtaining external assistance
- establishing a negotiation protocol
- agreeing the price
- segregating duties
- supervising the project
- conducting a post-completion evaluation.

Not all of the steps outlined below will be necessary in each case (for example, if the transaction is of low value), but agencies should adopt those controls that are appropriate to their projects.

Making the decision

The project itself should be based on the agency's own business case and should be congruent with its overall strategic direction. The agency should be under no obligation to agree to direct negotiations or an unsolicited proposal without undertaking the proper planning and budgeting.²⁵

Demonstrating need

A local council's management plan contains a section outlining the need for bush regeneration work in the area, but the council does not invite expressions of interest. However, a local bush-care group that has viewed the management plan approaches the council seeking \$2,500 in funding to regenerate a small section of local bushland.

The proposal is worthwhile and the council is keen to grant the funding. The amount of \$2,500 is small relative to the cost of advertising for expressions of interest in the local media and assessing the resultant responses.

The council therefore decides that since it has already publicly issued its management plan detailing bush rehabilitation as a future priority for the area, it can justify direct negotiations with the bush-care group for a grant of \$2,500.

²⁵ For procurement projects, any decision in relation to direct negotiations would normally be taken during the procurement strategy step of the process. This is the fifth in the 10-step procurement process devised by NSW Treasury. See: <http://www.treasury.nsw.gov.au/procurement/procure-intro.htm>.

For certain high-risk or high-value procurement projects, NSW agencies are required to submit to an independent ‘gateway review’²⁶ of the business case for the project.²⁷ This recognises that a robust business case is the key mechanism for mitigating a number of risks that could jeopardise the project. Budget-dependent agencies are also required to submit economic and financial appraisals of substantial projects to NSW Treasury as part of the budget process.

Agencies should ensure that the decision to enter into direct negotiations is made at a senior level within the organisation. The decision to negotiate directly should not be made by the person(s) or team who will be performing the negotiations or managing the project. Because of the gravity of entering into direct negotiations, the Commission suggests that agencies modify their financial delegation policies so that these decisions are elevated to a higher level than would be the case for more routine transactions. Indeed, if the project or contract is particularly sensitive or controversial, the decision to negotiate directly should be approved by the principal officer of the organisation or the minister or local council as appropriate.²⁸

Ensure the decision to enter into direct negotiations is made at a senior level

To avoid suggestions of impropriety, the agency should record the reasons it has chosen to enter into direct negotiations. In order to maintain transparency, it should, where appropriate, make the decision and supporting reasons public, possibly by placing a notice on the agency website. Ideally, the agency should also nominate which of the circumstances outlined in Chapter 2 of this publication are relevant. In some cases, the decision should be supported by a cost–benefit analysis or similar study that verifies that best value for money is being obtained.

Identifying and managing conflicts of interest

The agency needs to be confident that there are no financial or personal associations between its staff and the proponent that could influence decisions made by public officials. To lower the chances of negotiations being driven by private interests, all individuals party to the project should be required to sign a declaration stating that they are not aware of any conflicts of interest. This requirement should extend to staff working for the proponent, external advisers and internal staff. Failure to disclose a significant conflict of interest should trigger some form of legal or contractual consequence.²⁹

If post-separation employment is a potential concern, the agency might also seek an anti-poaching undertaking from the proponent to prevent it from holding out offers of employment to public sector staff.

In the event of poor performance, breaches of ethical conduct etc, the contract with the proponent should also allow for the agency to step in. The ICAC publication *Developing a Statement of Business Ethics* (June 2004), urges agencies to incorporate their expectations of ethical behaviour formally into their dealings with suppliers.

²⁶ For more details see the *NSW Government Procurement Policy*, TPP 04-1, July 2004. For certain acquisitions, use of a gateway review is mandatory at the business case stage of the project.

²⁷ See Attachment 5 of the *NSW Government Procurement Policy*, July 2004.

²⁸ For state government agencies entering into projects that involve private financing, any decision to enter into direct negotiations must be approved by the Budget Committee of Cabinet, as must the final contract. See NSW Government 2001, *Working with Government – Guidelines for Privately Financed Projects*, NSW Government, Sydney.

²⁹ Template declaration forms can be obtained from Independent Commission Against Corruption and Crime and Misconduct Commission 2004, *Managing Conflicts of Interest in the Public Sector Toolkit*, ICAC/CMC, Sydney & Brisbane.

Obtaining external assistance

Major acquisitions or projects often warrant the involvement or approval of central government agencies such as the Department of Commerce, Department of Local Government, NSW Treasury or the Department of Planning. Using the expertise housed within these agencies can help to address any shortfall in experience, skills or knowledge that the agency may be experiencing.

The NSW Treasury has introduced an agency accreditation scheme that requires unaccredited agencies to obtain external support for aspects of certain capital works projects. In concert with the overall risk profile of the project, an agency's accreditation status will provide an indication of the need for external assistance on any type of project. For more information, see *NSW Government Procurement Policy TPP 04-1*, July 2004.

In addition to using central government expertise, agencies may need to engage technical, legal, financial and/or probity advisers in order to satisfy themselves that direct negotiations risks are managed. Where applicable, agencies should seek this assistance at an early stage, before any corruption risks are likely to materialise. Importantly, they should use such external advice to supplement, but not substitute for, existing internal resources. If the agency does not have experienced staff members to lead and administer the project, it should be especially cautious about entering into direct negotiations.

The Commission also endorses the preparation of a probity plan that details the potential probity risks that could jeopardise the integrity of the project. For more details, see the ICAC publication, *Probity and Probity Advising – Guidelines for managing public sector projects* (November 2005).

Establishing a negotiation protocol

When an agency enters into direct negotiations with a proponent, it is common for many of the formalities associated with competitive tendering to be relaxed. This is misguided because it reduces transparency and increases the risk that the agency will be accused of favouritism.

The absence of competition does not absolve the proponent from having to justify and account for its contracted responsibilities. For this reason, the agency should establish and maintain an agreed negotiation protocol for direct negotiations. This should describe the manner in which meetings, negotiations, decisions, staff liaison, progress reports and so on are to be managed. It should also establish a time frame in which the negotiations are to take place, allocate any negotiation costs and assign responsibilities to the appropriate staff. The protocol should also contain a dispute resolution mechanism and establish a means of terminating the negotiations if necessary.

Having a negotiation protocol can help to prevent the proponent from taking improper advantage of a superior bargaining position or knowledge of the project. If the negotiations themselves take place in an ad hoc manner it is more likely that the agency will end up making concessions or agreeing to unnecessary departures from the business plan. If on the other hand the agency keeps an auditable trail of documentation relating to the project and the negotiation process, it enhances its

ability to defend itself against criticism concerning problems that may arise during the course of the project (including queries from agencies such as the Audit Office, the NSW Ombudsman or the Independent Commission Against Corruption).

Agreeing the price

Before signing a contract with the proponent, the agency should satisfy itself that, in the absence of competitive bidding, the price paid by or to the proponent is consistent with market values.

When conducting direct negotiations, it is standard practice to engage an independent expert to provide an estimate of the market or fair price of the transaction being considered.³⁰ While this estimate will not necessarily be equivalent to the price that would be obtained under open bidding, it should help the agency guard against paying too much or receiving too little.

In addition to benchmarking the price, the agency should obtain benchmarks for other contract deliverables such as the time frame, materials used, environmental impact and so on. Without such project benchmarks, the agency may weaken its bargaining position or unintentionally agree to undesirable concessions that reduce value for money. Agencies face heightened risks when they enter into negotiations with a proponent that has superior information about the project.

These estimates of fair price should not be disclosed to the proponent until after the proponent has put forward its own estimated price. Knowledge of the independent benchmark could lead to the proponent inflating its own estimate. In a direct negotiations scenario, the agency's own estimate of fair price is a surrogate form of competition and should be treated as though it were an offer from an alternative proponent.

Local council land disposal

Section 55(3) of the Local Government Act states that local councils do not have to invite tenders for the sale of land. However, the Commission recommends that where a council decides to sell a parcel of land to a proponent without inviting other expressions of interest, it should commission an independent valuer to provide an assessment of the fair price.

As the custodian and trustee of public assets (including land) under section 8 of the Local Government Act, local councils have an obligation to ensure that they obtain best value for money from land sales.

In addition to obtaining an independent valuation, it may also be reasonable to examine the methodology that the proponent has used to arrive at its own price estimate. The proponent should provide this information in the context of the considerable advantage conferred on it as the result of direct negotiations.

This methodology examination may involve scrutinising such details as the proponent's cost structure, profit margins and sub-contractor details, as well as accounts on similar projects. This practice is sometimes termed an 'open book'

³⁰ This is similar to the concept of a 'public sector comparator' that is used to test the viability of a privately-financed project.

relationship. If necessary, this examination can be carried out by a third party, such as the agency's accountant, legal adviser or technical adviser, or can be incorporated into the due diligence research that should be conducted by any organisation entering into a major contract.

Segregating duties

When a single member of staff is responsible for all aspects and phases of the project, the opportunities for corrupt conduct are expanded. To the extent possible, the different aspects of the project should be performed by different staff and key project decisions should not be made unilaterally. Segregating duties is good practice for all contracting situations, not just direct negotiations.

Larger projects should require a steering committee or similar mechanism for overseeing the key decisions made in respect of the project. Such a committee should include some members who are independent of the project and are thus in a position to challenge fundamental aspects of the project that might go undetected by an officer who is more personally involved.

Segregating duties

In an investigation into a council purchasing officer, the Commission found that he played a key role in almost every aspect of the procurement process from designing specifications, obtaining and evaluating bids, and awarding contracts.

This influence allowed him to leak confidential information to business associates, create 'dummy' bids to satisfy policy requirements, create false purchase orders and award contracts to firms that had paid him bribes.

In its report, the Commission found that there was an unquestioning reliance on the purchasing officer's recommendations and that his duties should have been better segregated.³¹

Supervising the project

Monitoring the work carried out by contractors is always important. However, in cases where a proponent has little to fear in terms of competition, the need to scrutinise performance is especially important. Agencies should also ensure that an apparent lack of competition or bargaining power does not adulterate the usual record-keeping and documentation processes. Any proposed variations to the project should be carefully scrutinised, especially if initiated by the contractor.

³¹ Independent Commission Against Corruption 1999, *Report on Conduct of Mr Sam Masri, Former Purchasing Officer, Liverpool City Council*, ICAC, Sydney.

Conducting a post-completion evaluation

Where an agency enters into direct negotiations, it should conduct a mandatory post-completion evaluation of the project. This evaluation or 'right-to-audit clause' should form part of the contract with the proponent and its purpose would be to assess value for money, the conduct of the proponent and whether the proponent should be considered for future work.

It is important that proponents understand that they have something to lose should they attempt to take advantage of the privileges conferred by direct negotiation.

Checklist for undertaking direct negotiations

- Using the general principles in Chapter 1 and the circumstances outlined in Chapter 2 of this publication, decide whether direct negotiations can be justified
- Verify that the project or proposal is consistent with the agency's overall strategic plan
- Check that there is an appropriate project or business case and that funding has been approved
- Ensure that the decision to enter into direct negotiations has been made or approved at a senior level within the agency
- Ensure that the decision to enter into direct negotiations and the reasons for it, are recorded and are publicly accessible
- Perform cost-benefit analysis or similar study to verify that direct negotiations will not sacrifice value for money
- Obtain conflict of interest declarations from persons associated with the project including staff, the proponent's employees and advisers
- Ensure that the contract entered into gives the agency the authority to intervene in the event of poor performance or unethical conduct
- Engage external assistance as necessary
- Prepare a probity plan
- Establish an agreed negotiation protocol
- Ensure that an auditable document trail is established
- Obtain an independent estimate of the price or financial consideration
- Establish project benchmarks for deliverable items
- Arrange for an 'open-book' relationship with the proponent
- Segregate duties
- Form a steering committee or similar oversight mechanism
- Supervise the project to ensure that the contract is adhered to
- Conduct a post-completion evaluation of the project to assess whether value for money has been obtained

Chapter 4: Scenarios: risks and remedies in contracting

In addition to the general principles outlined in Chapter 1, there are a number of specific risks that agencies should bear in mind when entering into contracts. To the extent possible, agencies should avoid situations where some form of lapse in probity can transform a process that is intended to be competitive into a de facto direct negotiation.

The risk scenarios and management options described below all relate to direct negotiations either explicitly or implicitly. They describe circumstances where unjustified direct negotiations can develop or where a competitive contracting process can be compromised.

Scenario 1 – The problem of capture

Where there is a close relationship between an agency and a contractor (for instance a supplier, a sponsor or a grant recipient), there is a risk that the agency and/or its staff will develop either an overly close relationship with, or dependence on, that contractor. This form of ‘capture’ can deter the agency from retesting the market, which in turn may lead to poor value for money. Capture tends to involve subtle influence and is often established over time or as a result of small favours or acts of friendship. A public official who over-identifies with a contractor may not even be aware of the fact and as such would be unlikely to contemplate or recognise any type of bias.

Captured agencies can be susceptible to offers or suggestions made with the intention of avoiding competition or persuading the agency to depart from its usual procedures. Where the agency allows itself to be persuaded by such special offers, it can lose effective control of the process and sacrifice value for money.

In cases where a project is conducted as a joint venture or partnership, the agency and its partner(s) are necessarily dependent on one another for the success of the project. While joint ventures can be a useful method for delivering projects and reducing risk, agencies should be wary of the possibility that capture will diminish its ability to exert control over the project.



Be wary that capture may diminish control over the project

Example

Following an EOI process, a local council appoints a firm to act as its financial auditor for a period of six years.

Over this period, the audit firm carries out its duties in a professional manner. However, in the last financial year of its contract, the firm detects some irregularities in the council's accounts and advises the director of corporate services. Reporting these irregularities might cause some embarrassment for the council's accounts department and for the director.

The director asks the firm's chief auditor what can be done to prevent an adverse audit finding. The chief auditor replies that the matter can potentially be overlooked but suggests that in order to maintain a consistent interpretation of the accounts in the future, it would be desirable if his firm were re-appointed as council's auditor.

In order to avoid unnecessary embarrassment, the director decides to re-appoint the audit firm without using a competitive process. His delegated authority allows him to make this decision without seeking further approval.

Remedy

The contracting process should be designed so that no one individual can decide the outcome unilaterally. For most contracts, the process should be scrutinised by multiple officers and key processes should be segregated. This decreases the probability that personal involvement or a sense of obligation will affect the contract. Substantial contracts should incorporate additional governance mechanisms such as a steering committee, periodic review by internal audit or a probity adviser. Where an evaluation committee is formed, the agency should consider appointing an independent committee member who has no relationship with any of the proponents.

Unsolicited offers or proposals from incumbent contractors that are contingent on the agency agreeing to direct negotiations should be treated with a high degree of scepticism. As a general rule, they should be market tested.

In addition, any unsolicited offers that seem worthy of consideration should always be tested against the agency's strategic or business plans. If the proposal has never before been identified by the agency as having merit, it should not proceed without a proper business case being prepared and funding made available.

Scenario 2 – Dealing with incumbent contractors

Agencies often have to manage the situation in which the contract of an incumbent contractor is about to expire. If the incumbent's work is of a high standard, the agency will probably have a good case for re-appointment. However, automatically re-appointing incumbents is a form of direct negotiation and carries a number of risks. Typically, and quite legitimately, incumbent contractors will have access to information about the agency and the contract that is not available to competitors. However, agencies need to make sure that these natural advantages do not cross over into unfair advantages that diminish or bypass what is intended to be a competitive process.

Example

Following a competitive bidding process, a government agency enters into a two-year contract with a private sector training firm, Acme, to deliver a range of education products informing the community about public health issues.

At the end of the two-year period, Acme has successfully delivered a range of educational products to communities across New South Wales. As a result, the agency decides to continue the program indefinitely.

Acme then approaches the agency and suggests that the existing contract arrangement be renewed automatically. It also recommends a 15 per cent increase in its fee, to be reviewed annually.

The agency decides that direct negotiations would be inappropriate and instead decides to seek fresh expressions of interest. The original contract with Acme nominated a fixed two-year period and did not contain an option for renewal.

However, because of Acme's superior performance, the agency includes assessment criteria requiring the successful proponent to have a reliable track record, experience in working with government and good management.

A number of attractive proposals are received, including one from Acme that improves on the terms of its earlier proposal, both in terms of price and quality of service. Following an evaluation process, Acme is awarded the new contract.

Remedy

It is not acceptable to automatically re-appoint an incumbent whose fixed-term contract is about to expire. To do so would defeat the purpose of having a fixed-term contract in the first place. Instead of automatic re-appointment, it may be acceptable to include an option for renewal in the original competitive process on the basis of demonstrated good performance. However, the agency should exercise this option so that it is not locked in to a relationship that it cannot end. In addition, to avoid capture and the possibility of a conflict of interest, the agency's assessment of the contractor's performance could be verified at regular intervals by someone other than the officer responsible for the contract, such as a person from internal audit.

When the time comes to renew a contract, it would be reasonable for the incumbent's performance to have a bearing on the specifications drawn up for the new contract. Provided that this new specification corresponds with the genuine needs of the agency, any advantage or disadvantage that might be conferred on the incumbent is probably fair.³² However, agencies should avoid drawing up specifications that deliberately cater to the incumbent or unreasonably limit competitors from making viable offers. In addition, the incumbent should not be directly consulted as to what the new criteria might be, nor should it receive advance notice of the criteria.

³² For contracts covered by agreements such as the Australia–United States Free Trade Agreement it may be improper to include previous work experience or performance as an evaluation requirement. See NSW Treasury Circular 04/11, December 2004 for further details.

Scenario 3 – Varying and extending contracts

A common issue in dealing with incumbents concerns the granting of variations or extensions to existing contracts. When an incumbent supplier approaches the agency with a proposal to substantially expand the scope of work, it is a form of direct negotiation. Even where it is the agency that is suggesting the variation or extension, negotiating directly with the current contractor can breach the general principles outlined in Chapter 1.

Example

Pratt Contractors Limited v. Transit New Zealand (Privy Council Appeal No. 84 of 2002)

In this case the tendering company, Pratt Contractors, was viewed by members of the tender evaluation team as having a reputation for “low-balling” on road building projects, that is, tendering a low price initially to obtain a contract in the expectation of successfully claiming for additional payments at a later stage.

Pratt Contractors’ inability to demonstrate a record of completing contracts without undue delays or substantial cost over-runs was used by Transit New Zealand’s tender evaluation team, in part, as a reason to award the contract to another proponent.

On appeal, the Privy Council found that the members of the tender evaluation team were entitled to express their honestly held views about Pratt Contractors’ business methods and lack of competence as part of the decision-making process.

Remedy

Contracts should contain provisions for minor variations in the contract work to be performed and hence the price. However, where proposed variations are not minor, the agency should consider whether a competitive process needs to be reopened.

For certain high-risk, high-value projects, the NSW Treasury requires applicable agencies to provide a Material Variations Report, providing the details of the proposed variation.³³ ICAC recommends that agencies adopt a similar system of reporting material or anything more than minor variations in all projects up to a more senior level of the agency for review. Such reviews should consider whether the variation is consistent with the business case, whether it continues to give best value for money and whether the proposed variation should be exposed to a competitive process.

What constitutes a material variation will depend on the type of contract being considered. For example, for consulting contracts, the Premier’s Department of NSW has nominated a variation of 25 per cent as a threshold for thorough contract review:

*All proposals for variations require very careful consideration, applying the principles of value for money, probity and accountability. Proposals to increase the value of the consultancy by 25 per cent or more demand a particularly thorough review.*³⁴

³³ See Attachment 6 of the NSW Government Procurement Policy, July 2004.

³⁴ Premier’s Department of NSW July 2004, *Guidelines for the Engagement and Use of Consultants*, Version 4, Premier’s Department of NSW, Sydney

However, for other types of contract, proposed variations of less than 10 per cent could be considered material.

Finally, as suggested in the example, agencies should consider including contractors' track record or experience on similar projects as part of the evaluation criteria and should conduct thorough reference checks.

Scenario 4 – Dealing with oligopolies

A market that has only a small number of competitors is called an oligopoly. Firms that form part of an oligopoly tend to exhibit behaviour that is different from firms in competitive markets. Even in the absence of formal collusion, oligopolies are less likely to respond to open tenders with highly competitive quotes. Instead, they may frame their bids based on their knowledge of their competitors' likely responses. This strategy tends to generate higher prices than those likely to be obtained in a fully competitive market.

Oligopolies present an added risk of shared information or even formal collusion. The Australian Competition and Consumer Commission (ACCC) has warned that government procurement is particularly exposed to anti-competitive behaviour and cartels.

By avoiding the likelihood of anti-competitive behaviour, the agency ... potentially saved taxpayers a considerable sum of money

Example

A state government agency wanted to lease some public assets but discovered that the market for these particular assets was an oligopoly. The small number of companies that comprised the market had formed a peak body and in the circumstances, there was a genuine likelihood that a competitive tender may have produced less than competitive bids from the individual companies.

At ICAC's suggestion, the agency considered the four general principles of:

- obtaining best value for money
- providing a fair chance to do business with government
- demonstrating accountability and transparency, and
- dealing with conflicts of interest.

As a result, the agency decided that direct negotiations with the peak body (that was acting as the industry bargaining agent) could be justified. This in turn meant that every company in the industry was able to lease the assets, and at a fair price.

By avoiding the likelihood of anti-competitive behaviour, the agency was able to negotiate an offer that potentially saved taxpayers a considerable sum of money without depriving any potential bidder of the opportunity of doing business with government.

Remedy

Where a market is an oligopoly there may be limited value in operating a conventional open tender based on a public advertisement. However, it would be inappropriate to completely abandon a competitive process. Instead, it may be appropriate to conduct an abbreviated selection process by inviting selected firms to tender and/or establishing panels of pre-approved contractors.³⁵ It may also be appropriate to include a degree of face-to-face negotiation with the selected proponents which can make it easier for oligopolistic firms to behave competitively or for the agency to detect anti-competitive behaviour.³⁶

Where collusion or other forms of anti-competitive behaviour are a possibility, a departure from the traditional open-competition model may be appropriate, provided the agency considers the decision in a business case or procurement plan context and it seeks appropriate external advice. Importantly, where there is evidence of collusion, the ACCC should be alerted.

How to recognise a cartel

Cartel behaviour typically includes price fixing, market sharing, bid rigging and/or production quotas. This behaviour is illegal and can also amount to corrupt conduct.

The ACCC has published guidance on cartel behaviour. The following are warning signs:

Industry conditions:

These factors make it easier for competing suppliers to reach unlawful agreements:

- It is difficult or costly for new suppliers to enter the industry.
- There are only a few suppliers, or a small group controls most of the market.
- Suppliers have similar costs, or fixed costs account for a high proportion of total costs.
- There is an active trade association which gives competitors the chance to meet and discuss the industry.
- The product or service is straightforward, is a commodity or has few close substitutes.
- Demand for the product is stable and market share is important.

Behavioural signs:

Certain kinds of behaviour by suppliers may also indicate that a cartel is operating. Some of this behaviour may have a legitimate explanation but it is a good idea to look more closely when these behaviours occur.

- Prices, discounts or rebates offered by suppliers are very similar or identical.
- Unexpected or unjustified price increases occur, or different suppliers raise their prices by similar amounts at the same time.

³⁵ For local councils, this process is covered by clauses 168 and 169 of the Local Government (General) Regulation 2005.

³⁶ See OECD 1999, *Competition Policy and Procurement Markets*, OECD.

- Suppliers charge different prices in certain geographic areas.
- Price changes suggest that one supplier is the 'leader' and others follow.
- The range of quoted prices has narrowed suddenly, or existing discount arrangements have changed suddenly.
- Suppliers meet before they submit tenders.
- Tender offers are much higher than estimated.
- Suppliers that would normally tender fail to do so.
- The same supplier is often the lowest tenderer.
- Prices drop when a new supplier tenders.
- The successful tenderer sub-contracts work to its competitors that submitted higher tenders.
- Tenders have similarities, such as identical spelling errors, miscalculations, or one firm representing several tenderers.
- Suppliers use the same words or ideas when explaining price increases.
- A supplier says that it cannot sell because of an agreement with another firm.
- A supplier says that another supplier should not have sold.

Source: *Cracking cartels: Warning signs during the procurement process*, ACCC, July 2005.

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See www.accc.gov.au for more information on cartels.

Scenario 5 – Cutting corners

One of the main reasons why direct negotiations are misused is that they are convenient. Agreeing to direct negotiations can avoid the expense and trouble of placing advertisements, preparing evaluation criteria and a panel and generating correspondence. Similarly, if staff responsible for contracting are under-resourced or under pressure to meet deadlines, the temptation to take short cuts is increased. Time pressure due to poor planning is not a valid reason for entering into direct negotiations.

Order splitting is a short cut to direct negotiations that improperly avoids the competitive process. This involves dividing a transaction into smaller components with a view to keeping the value below thresholds that, under agency policy, require additional bids. While order splitting is usually indicative of a rushed process or inadequate planning, in some cases it may be driven by a corrupt motive.

Order splitting often entails quotations being made at just below the relevant threshold or multiple contracts of a similar nature being awarded to the same firm in a short period of time.

Example

Steve, a procurement officer at a government agency, is asked by his manager to engage an external firm to install new IT security software for all the offices that the agency manages throughout New South Wales.

Steve drafts some specifications, makes a number of preliminary enquiries and concludes that the project will cost approximately \$45,000.

Agency policy states that acquisitions of more than \$30,000 must be made on the basis of three written quotations. Acquisitions of less than \$30,000 may be made on the basis of just one written quotation.

Steve is about to go on a fortnight's annual leave and is worried that he will not have time to complete the job in line with his manager's expectations.

To save time Steve decides to split the job into two halves, one contract for the Sydney metropolitan area and one contract for the rest of New South Wales, which allows him to obtain just one written quotation for each contract. Steve telephones an IT firm that he knows and asks for quotations for the two 'separate' contracts, telling the proprietor of the firm that the quotations need to be below \$30,000 to suit the agency's needs.

The IT firm is then awarded the two contracts, each for \$29,000.

Remedy

Policies and procedures for different types of contract should not be bypassed just to meet a deadline. All work done should leave a paper trail that can be audited and that can reveal any departures from policy or suspected corruption. For instance, continuing the example above, if Steve is forced to advise his manager and keep a record of his original \$45,000 estimate, his final contracts for \$58,000 (2 x \$29,000) will raise obvious questions.

To the extent possible, the contracting process should not be left in the hands of just one public official. If the task is separated into different components, breaches of policy are more obvious. In addition, agency auditors and accounting staff should be familiar with the relevant thresholds at which multiple bids are required and watch for the warning signs of order splitting.

Scenario 6 – Contractors as customers or stakeholders

Given the widespread operations of many public sector agencies, it is not unusual for contractors to also be clients of, or stakeholders in, the agency.

Where this is the case, the potential exists for one aspect of the relationship to inappropriately affect the other. There is an obvious danger that one party will feel obliged to offer or seek reciprocal gestures from the other. For example, if a contractor is also an important stakeholder, it may feel entitled to preferential treatment when the time comes to renew its contract.

Example

- The community representative on a local council's traffic advisory committee submits a proposal to purchase council's surplus computer equipment.
- A family business provides paid lawn-mowing services to the local school that is attended by the business owner's children.
- A firm that supplies pathology services to an Area Health Service (AHS) applies for a medical research grant administered by that AHS.
- An agency may receive an unsolicited sponsorship proposal from a company that is bidding for a lucrative construction contract.

Remedy

There are certain situations where agencies should simply avoid having multiple relationships with private firms altogether. For instance, ICAC sponsorship guidelines³⁷ state that agencies with regulatory responsibilities should avoid entering into sponsorship arrangements with bodies or persons that are subject to regulatory oversight.

Where the two types of relationship cannot be avoided, the Commission recommends that as a minimum requirement public officers' roles should be segregated so that they are responsible for only one aspect of the relationship. That is, officers managing an agency's relationship with a private firm that is a supplier should not also be managing relationships with the same firm where it is acting as a customer, sponsor, development applicant and/or any other role. It may also be appropriate to engage independents to participate in evaluating proposals.

In addition, an agency's contracts should oblige the parties to divulge any associated relationships and where practicable, stipulate the required degree of segregation.

³⁷ Independent Commission Against Corruption, *Sponsorship and the public sector – a guide to developing policies and procedures*, forthcoming.

Scenario 7 – Complex and multi-stage projects

In the case of complex projects, undertaking market analyses, cost–benefit analyses, feasibility and scoping studies, community consultation, environmental assessment and so on is not only good practice, it also contributes to the effectiveness of any subsequent RFT/EOI documents. In addition, these exercises are usually vital to the ultimate success of the project.

Be wary of consultants seeking to implement their own recommendations

If a firm or provider has been involved in these preliminary phases of the project, there is a possibility that it will also be interested in bidding for subsequent stages. If these firms do bid for further work, they may enjoy a significant advantage over their competitors and could potentially win the contract on grounds other than merit. This is especially the case where a proponent has been able to influence the evaluation criteria or has advance notice of the criteria.

Any time a particular proponent has information about a key aspect of the project that is not available to its competitors, the ‘contest’ can rapidly assume the characteristics of a direct negotiation.

Agencies should also be wary of consultants or advisers seeking to involve themselves in implementing their own recommendations. Wherever possible, consultants should not be in a position where the consequences of their advice can generate further income for themselves or a related party.

Example

The Commission investigated an agency that was required to implement a number of environmental projects. In order to manage and oversee these projects, the agency established a steering committee composed of senior managers, staff and a private sector industry expert with technical knowledge in the field.

As each project progressed, the steering committee was required to approve business plans, set budgets for the work and monitor progress.

While sitting on the steering committee, the industry expert learned a great deal about the plans and aspirations of the agency and in fact, played a key role in shaping them. As a result, his firm decided to bid for a number of contracts that were let by the agency – and won all of them.

The industry expert’s firm had an unfair advantage over its competitors. These competitors, if given the opportunity to bid on a level playing field, could conceivably have offered better quality and value for money to the agency. In addition, the industry expert could have provided biased or self-serving advice to the steering committee once he decided to bid for the available environmental work.

Remedy

The Commission suggests that agencies address this problem using the following options:

- If an initial contract could foreseeably lead to subsequent work, the process of engaging a contractor should be open and competitive, even if the initial contract is relatively modest or would normally require only one bid.
- Provided this will not restrict competition or affect the agency's ability to obtain best value for money, engage contractors working on initial contracts on the basis that they cannot participate in future stages.
- If it is impractical to exclude contractors from participating in subsequent stages, make it clear that the winner of the initial contract will be permitted to bid for subsequent work. Where practical, ask proponents bidding for the initial contract to submit a schedule of hourly rates or fees that could be used as an indicative bid for subsequent work.
- Where contractors working on the initial stage(s) of a project are allowed to bid for further work, ensure that the contractors' competitors have full access to all aspects of the project including studies, working papers, site visits, discussions with management etc. To the extent possible, this should equip all potential bidders with the same insight into the project. Competitors should also be made aware of the prior involvement of the initial contractor(s).
- Consider extending response times so that the contractor working on the initial stage(s) of the project does not receive an advantage based on its advance notice of subsequent contracts.
- Use a 'two-envelope' system whereby different aspects of each bid are evaluated separately. This may help to reduce any benefit that accrues to a proponent that has worked on previous phases of the project. It may even be possible to conceal the identity of proponents when evaluating certain criteria.
- To the extent possible, ensure the evaluation criteria can be assessed objectively and that the weighting on non-price criteria is not too low.
- Ensure that there is at least some turnover in the membership of the evaluation committee as subsequent contracts are awarded. This helps to manage potential capture risks. The evaluation committee could also include independent people who are not familiar with the services of the initial contractor.

Scenario 8 – Free samples, trial periods and pilot projects

Free samples and ‘try-before-you-buy’ promotions are common marketing techniques designed to tempt potential customers into using a product. Agencies should be wary of accepting goods and services that are offered free of charge as this may create an actual or perceived sense of obligation to forgo a competitive process.

Accepting free samples from one potential proponent but not others may taint any future tendering process and is a practice that could lead to allegations of bias and unfairness.

Other practices, such as conducting pilot projects or using prototype products in order to test an idea or concept before fully committing funds, may have similar consequences, affecting or seeming to affect the agency’s ability to evaluate proposals impartially.

Example

A local council decides to publish a community newsletter outlining its recent activities and forthcoming events.

The council is not sure whether it will publish the newsletter on an ongoing basis and so decides to contract a local business, Pete’s Printing, to produce a one-off print run of 15,000 newsletters. Pete’s Printing sets up the layout of the newsletter including the different fonts and artwork, council’s logo, photographs of the councillors and other design work. Sensing a future business opportunity, Pete’s Printing provides council with a sizeable discount on this initial print run.

The council is very happy with the reaction to the first newsletter and decides to issue further editions on a biannual basis. Because of the good deal from Pete’s Printing, the council suggests that the print company be awarded the newsletter contract on an ongoing basis.

However, council’s corporate affairs director argues that council has no obligation to stick with Pete’s Printing and arranges for a number of competing printing companies to lodge bids and provide sample newsletters. The director also allows all proponents to make a presentation to the evaluation committee, which includes an independent person not involved in the initial trial. The evaluation process shows that a number of companies are capable of producing high-quality newsletters, many at a better price than Pete’s Printing. As a result, council awards the newsletter contract to a competitor, thereby creating meaningful savings for council over the life of the contract.

Remedy

While it would be an over-reaction to refuse all approaches made by the private sector, agencies should ensure that any introductory offers are truly obligation-free and do not lead to them agreeing to direct negotiations or to conferring unfair advantages on a supplier.

Where possible, trials and pilots should occur within the context of a competitive process whereby multiple proponents are given the opportunity to participate. The objective of a trial or pilot project should be to assess the viability of a general concept or application – not a specific brand or contractor.

In addition, agencies can use the options presented in Scenario 7 on “Complex and multi-stage projects” to minimise any unfair advantage that a proponent might gain from being part of a trial or pilot project.

Scenario 9 – Specification error

Preparing specification or RFT documents is rarely straightforward. Agencies need to be precise in describing the items or services to be bought, sold or provided. If the specifications are too broad, it may be difficult and time-consuming to assess the responses.

Conversely, if the specifications are too narrow, deserving proponents may find themselves unnecessarily excluded from providing an attractive bid because of some minor technical detail.

Agencies should frame specifications as broadly as possible

Example

While attending an exhibition, engineering staff from a public agency saw a manufacturer demonstrate a new surface treatment for external walls. The staff were impressed and advised the manufacturer to bring the product to the attention of a number of builders who were preparing bids for a current repair contract.

The manufacturer sent out detailed information on the product to the potential tenderers. One was very interested, but told the manufacturer that he could not use the product because the tender documents specified a different brand.

In the meantime, the agency was advised by its legal department that because a particular brand had been specified, any tender proposing to use a different brand would have to be disqualified as a non-conforming tender.

In circumstances like these, staff assessing the tenders are put in a difficult position. They want to select the best product or service, but if they choose a non-conforming solution there could be accusations of partiality, impropriety and possible legal action. When tender specifications are framed too tightly, acceptable solutions may have to be eliminated, leaving the organisation to negotiate with a limited pool of proponents, or worse, a single proponent.

Remedy

Agencies should avoid using brand names in specifications unless it is imperative that a particular item be compatible with existing equipment. For instance, it would be reasonable for an agency with Brand Z photocopiers to only order spare parts suitable for Brand Z machines.

Local preference policies are a form of narrow specification that can unnecessarily limit competition and lead to de facto direct negotiations. The Commission does not advocate the use of local preference policies and believes they represent a corruption risk. This is because they are anti-competitive in application and create circumstances in which conflicts of interest can arise.

To maximise competition and the range of possible solutions, agencies should frame specifications as broadly as possible and take care when dividing criteria into 'essential' and 'desirable' categories. RFT documentation can also reserve the agency's right to accept non-conforming proposals or make minor departures from the announced process. However, any such departures should not be relied upon as an excuse for preparing incomplete or ambiguous documentation.

Scenario 10 – Conflicts of interest

If a member of staff has a conflict of interest that could dispose him or her to favouring or excluding a particular proponent, then the process may effectively amount to a direct negotiation, that is, the competitive process is not genuine. It is common for the Commission to receive allegations that a public official has directly engaged a proponent who is a relative or a personal friend.³⁸ Alternatively, the public official may have a direct financial interest in the proponent (perhaps as a shareholder or through a second job).

Another form of conflict that is often overlooked is post-separation employment. This can create two types of conflict – firstly a proponent may make promises of future employment to current employees of an agency, thereby creating a bias, and secondly, former employees of an agency may be currently working for a proponent and therefore have personal relationships with former colleagues.³⁹

Case Study – Dealing with recommendations

The Commission investigated an agency that was bypassing its procurement policy and awarding contracts to a supplier via direct negotiation. This occurred because a senior manager in the organisation was recommending this particular supplier to the more junior staff responsible for procurement.

The agency's procurement policy required three quotes to be sought for this type of supply, but the staff involved felt that they had no alternative but to accept the recommendation from their more senior manager.

The Commission's investigation revealed that the senior manager and the supplier were in fact friends and a serious conflict of interest existed.

³⁸ Note that the allegations reported to the Commission are not necessarily substantiated in every case.

³⁹ For detailed advice, see Independent Commission Against Corruption and Crime and Misconduct Commission 2004, *Managing Conflicts of Interest in the Public Sector Toolkit*, ICAC/CMC, Sydney & Brisbane.

Remedy

When entering into direct negotiations, especially if it contravenes agency policy, all relevant staff and the proponent should sign conflict-of-interest statements declaring that there is no interest that could influence their behaviour. Failure to disclose known conflicts should attract some form of consequence, including cancellation of the contract.

Agencies should ensure that the relevant aspects of their codes of conduct are incorporated into the contracting process and that the people performing official functions including contractors, delegates and advisers are aware of their obligations.

Scenario 11 – Poor continuity planning

A common problem in public sector contracting is the failure to anticipate the impending expiration of period contracts or looming deadlines. Agencies should start retesting the market well before the expiry date of an existing contract or appointed deadline. If a new contract is unlikely to be in place by the time the old one expires, then the incumbent contractor can have significant bargaining leverage. Leaving things until the last minute also carries the risk that the responsible officer will simply engage a contractor he or she thinks might be able to do the job, or worse, a contractor with whom he or she has a personal relationship, such as a friend or relative.

Poor planning also creates a risk of corrupt conduct if the public official responsible for managing the contract puts him or herself in a position where he or she is dependent on the incumbent to maintain continuity of the service. Where a dependency exists, corrupt conduct is more likely to follow.

These risks also apply to activities such as making grants to non-government organisations. If an agency is required to distribute a certain amount of grant funding each year and it does not plan ahead or monitor performance, then it runs the risk of granting money inappropriately to an organisation by direct negotiation.

When a dependency exists, corrupt conduct is more likely to follow

Example

The following EOI notice was issued by a government agency:

“The PQR Department’s current prequalification for earthmoving contractors has expired. The Department is now seeking earthmoving contractors to apply for pre-qualification, for work in excess of \$50,000.

Contractors who have a demonstrable capacity to provide a high quality of service and specific expertise in earthmoving on construction sites are invited to register their Expression of Interest by contacting ...”

By waiting until after the existing period contract had expired before issuing the new EOI, the Department placed itself in a potentially difficult situation. If the need for earthmoving services arises before a new set of contractors can be pre-qualified, the Department will have to ask an out-of-contract supplier to do the job. This interim arrangement may create a sense of obligation to the supplier and/or give it an unfair advantage when applying for a place on the new pre-qualified contract.

Remedy

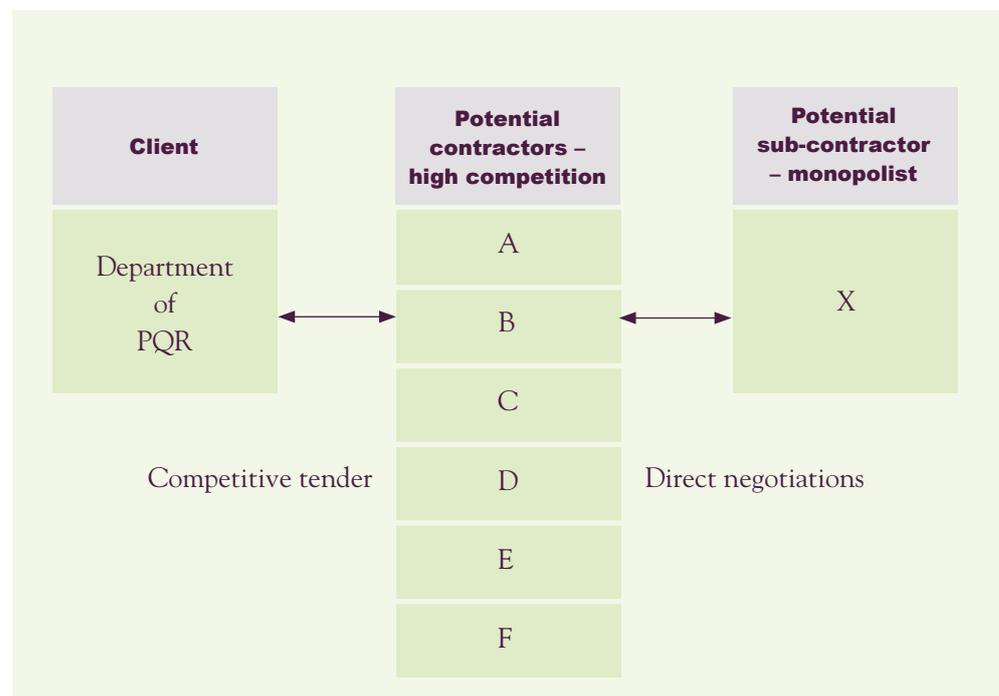
Agencies should administer contracts so that key dates are flagged and preparations for the new EOI and subsequent processes can begin in a timely manner.

If the agency is forced into de facto direct negotiations because of a lack of planning, it should award a short-term, interim contract while a competitive process is being finalised, rather than avoid competition altogether.

Scenario 12 – Sub-contracting

When an agency engages a contractor to supply goods and services, the contractor will often have a range of sub-contractors and suppliers that will be making some form of contribution to the primary contract.

If competition at the sub-contractor level is weak or non-existent, then the eventual client (i.e. the agency) may end up bearing the cost of direct negotiations taking place further down the supply chain.



Remedy

For routine projects it may be unrealistic for agencies to be aware of the full details of each proponent's sub-contracting arrangements. However, it is certainly reasonable to ask potential contractors to indicate the share of the contract that they intend to sub-contract to third parties. For major projects or acquisitions, a greater level of detail is required in terms of the actual sub-contractors to be used and their cost structure. Agencies may also need to ensure that they monitor the quality of work undertaken by sub-contractors that enjoy a degree of monopoly power.

Scenario 13 – Disposals to staff

When an agency has surplus or used assets, it is common for a member of staff to make an offer to acquire them. Such assets can range in value from small items of office equipment or stationery to land and dwellings. Disposals to staff can also include proposed buy-outs of discrete units or divisions of the agency itself.

Example

A state-owned corporation owned a number of houses in rural and regional New South Wales that it rented to employees who worked in those areas.

One of the corporation's employees who was also a tenant in one of these houses decided to retire and offered to buy the house from the corporation at a 'fair price'.

The corporation agreed that the property was surplus to its operational needs and sought advice on how best to dispose of it.

The Commission advised that although the retiring employee had offered to pay a fair price for the property, best value for money could only be assured by putting it on the open market.

The corporation followed this advice and the retiring employee was successful in acquiring the property at auction. This outcome allowed the corporation to demonstrate that it had in fact obtained best value for money while following a transparent process with no suggestion of favouritism.

Remedy

On page 21 it was noted that when the value of a contract or transaction is very low relative to the cost of conducting a competitive process, then direct negotiations may be justified. In some cases this may justify selling surplus assets directly to staff, although a competitive process among interested staff may still be required. If an agency makes such a decision, it should record this decision in writing.

Where it is practical to conduct a competitive process, it would be inappropriate to enter into direct negotiations with staff. For assets that are low in value, it may be practical to accumulate a number of items and then dispose of them as a single lot or to conduct an auction of numerous low-value assets.

Finally, in certain circumstances it may be inappropriate for staff to be permitted to purchase surplus assets, even if they are sold via a competitive process such as a public auction. For example, staff responsible for ordering supplies may have an incentive to over-order if they believe that they can acquire the excess for their personal use. Alternatively, staff may intervene so that assets are put up for sale prematurely.⁴⁰

⁴⁰ For more information on disposals, see NSW Treasury, September 2004, *Total Asset Management Manual – Asset Disposal Strategic Planning*, TAM 04-4, NSW Treasury, Sydney.

Scenario 14 – Non-price-based competition

Some types of public projects or acquisitions are incompatible with an evaluation process based on price. In these cases, the selection process tends to be based entirely or overwhelmingly on qualitative criteria such as previous experience, reputation or performance at an interview.

Relying on qualitative, subjective criteria to evaluate proposals can create opportunities to exercise bias or even corrupt conduct.

Example

Some of the contracts that cannot easily be awarded on price, or price alone, include:

- commissioning works of art or public entertainment
- performing scientific research
- obtaining expert witnesses in legal proceedings
- projects where the agency reveals its budget, and
- alliance contracting (see discussion in Appendix 2).

Remedy

Selection in the absence of price criteria can still be competitive. Agencies should conduct a rigorous comparison of the criteria in place. Where the size of the project justifies it, the criteria should be weighted and scores generated. For smaller undertakings, the agency should perform and document the necessary market research before deciding on a course of action.

To reduce the possibility of bias, the evaluation process should be carried out by a number of officers. For instance, the process of commissioning a public work of art should involve a selection panel and/or a steering committee.

Scenario 15 – Design competitions

Design competitions can be a useful method for generating innovative ideas from the private sector for projects such as works of art or public spaces. In a sense, they are an informal type of EOI process. However, if these competitions are poorly managed, the agency may be forced into direct negotiations.

Example

A city council had a very plain town square and decided to conduct a sculpture competition. The council appointed a panel to judge the entries and promised to purchase the winning work of art for \$5,000 and place it on public display.

After judging, council discovered that only a small number of entries were received and the winning entry was a sculpture of a bowl of fruit. The councillors were very disappointed but in order to comply with the terms and conditions of the competition, they were obliged to purchase the sculpture for the agreed price and place it on display.

Remedy

When conducting design competitions, agencies should be careful to ensure that the terms and conditions of the competition do not confer unintended contractual rights on the winner. Agencies need to ensure that unrealistic promises are not held out to the competition entrants, such as the right to a lucrative contract.

Equally, using an idea generated from a design competition or similar process, without proper compensation and acknowledgement, could be either unethical or a breach of intellectual property rights.

Appendix 1: NSW legal instruments relating to direct negotiations

- Section 11 of the *Public Finance and Audit Act 1983* requires agencies to maintain an effective system of internal control over financial and related operations. This includes a requirement for sound practices for the efficient, effective and economical management of functions by each organisational branch or section within the agency.

- Clause 16(3) of the *Public Sector Management (Goods and Services) Regulation 2000* states that:

If a period contract is arranged by the [State Contracts Control] Board (SCCB), Departments must use that contract for obtaining goods and services to which it applies.

This requirement applies to the NSW public service as defined in the *Public Sector Employment and Management Act 2002* and outlined in Schedule 1 of that Act.

According to delegations published by the SCCB and the NSW Premier's Department, affected agencies may buy and sell goods and services that are not available through an SCCB period contract. These delegations are issued under the *Public Sector Management (Goods and Services) Regulation 2000* and they set thresholds at which agencies may proceed without obtaining written quotations or on the basis of just one written quotation. These thresholds are for the areas of general purchasing, disposals, consultancies and printing. They are re-issued from time to time and agencies should consult the SCCB for advice.

- Most NSW government agencies are covered by the NSW Government Procurement Policy (July 2004) (<http://www.treasury.nsw.gov.au/pubs/tpp2004/tpp04-1.pdf>), the Code of Practice for Procurement (January 2005) (http://www.treasury.nsw.gov.au/procurement/cpfp_ig.htm) and the *NSW Government Tendering Guidelines* (November 2005) (<http://www.dpws.nsw.gov.au/Home.htm>).
- Agencies engaging consultants should follow the advice contained in *Guidelines for the Engagement and Use of Consultants*, Version 4, Premier's Department of NSW, July 2004 (http://www.premiers.nsw.gov.au/our_library/business/ConsultantsGuidelinesV4.doc).
- Most agencies entering into privately financed projects must follow the *Working With Government – Guidelines for Privately Financed Projects*, November 2001 (<http://www.treasury.nsw.gov.au/wwg/>).
- In relation to disposals, most agencies are bound by the Total Asset Management Policy. See Total Asset Management (TAM) Policy – Reconfirmation, NSW Treasury Circular 04/09 (August 2004) and the *TAM Manual*, NSW Treasury (September 2004) which covers disposal, capital investment, maintenance and office accommodation.

- For local government, entering into contracts is generally covered by section 55 of the *Local Government Act 1993*, Part 7 of the *Local Government (General) Regulation 2005* and the related guidelines issued by the Department of Local Government.

While local councils are generally required to submit contract opportunities to varying degrees of competitive tendering, there are a number of areas where this requirement does not apply. Examples include the purchase or sale of land, contracts with other public sector agencies, contracts made in an emergency or contracts estimated to be less than \$150,000.

- Local councils entering into public–private partnerships are bound by sections 400B–400N of the *Local Government Act 1993* and the related *Guidelines on the Procedures to be followed by Local Government in Public–Private Partnerships* (DLG Circular 05/51, September 2005).
- State-owned corporations are not bound by many of the statutory provisions that apply to the rest of the public sector. However, sections 19 and 20X of the *State Owned Corporations Act 1989* require certain acquisitions, disposals and investments to be approved by the voting shareholders.

Appendix 2: Alliance contracting – the ICAC view

Alliance contracting is a relatively new form of engagement that has some similarities with direct negotiation. In particular, alliance contracting requires that agencies negotiate with a preferred proponent before a proposed cost has been agreed.

Alliance contracting entails the formation of a single project entity comprising the client agency or agencies and the preferred proponent/s. The entity agrees to work on a non-adversarial, ‘best-for-project’ basis and to avoid resorting to legal action where disputes arise. It is claimed that when dealing with complex projects and unforeseen obstacles, this non-adversarial approach can assist in avoiding time and cost over-runs. The project entity agrees to pool uninsurable risks and take collective responsibility for dealing with the consequences, should any of these risks materialise. Similarly, any gain or windfall from the project is shared among the alliance partners. This differs from more traditional contracts which allocate responsibility for specific risks and over-runs to individual parties.⁴¹

For the purposes of this publication, the key feature of an alliance contract that differentiates it from more conventional projects is that the proposals lodged by proponents are not evaluated on price. Instead, the selection of the preferred proponent is based on non-price factors such as proposed solutions, experience, financial backing, environmental and safety credentials and the composition of its project team. Potential proponents usually attend lengthy workshops with the agency where their proposals are discussed and assessed and a preferred proponent is selected. A target cost for the project is not negotiated until *after* the preferred proponent has been selected. For this reason, alliance contracting can be considered a hybrid form of direct negotiation. Nevertheless, the Commission believes alliance contracting can be beneficial for certain projects, provided the risks are properly managed.

Some of the probity risks associated with alliance contracting include:

- allowing irrelevant considerations to affect the selection of a preferred proponent. The absence of price or cost as a selection criterion can create an environment in which personal factors can shape the final decision.
- overly subjective or poorly defined selection criteria. For instance, a good performance at a workshop is not necessarily a reliable indication of future performance on the project. Subjective criteria are also difficult to weight and score.
- the opportunity during lengthy workshops with proponents for inappropriate conversations, exchanges of information, inducements etc. to occur.
- reliance on a non-adversarial approach to conflict resolution and a ‘best-for-project’ approach, which may lead to the parties forming too close a relationship. This may in turn lead to ‘capture’ by the private sector proponent/s and a failure to consider the overall public interest. Capture can also be a problem if the ‘partnership’ is lopsided to the extent that the agency develops a dependence on the proponent/s for information and advice.

- negotiating the target cost of the project after the preferred proponent has been selected, which may remove or dilute the competitive tension that would be present under normal bidding conditions. In this scenario, the successful proponent may have the opportunity to increase the agreed cost or over-design the project.
- inexperience in dealing with the complexities of selection and negotiation. It is unlikely that most agencies will be equipped to manage the processes of alliance contracting on their own and a range of independent external advisers is generally required.

The key to managing these risks is to design an evaluation and selection process that is resistant to any suggestion of bias. It is desirable that this process is not materially altered once it has commenced and that auditable document trails are left that will help the agency to demonstrate its accountability. To the degree practicable, agencies entering into alliance contracts should also consider the advice on how to undertake direct negotiations given in Chapter 2 of this publication.

There is a variant of the alliance contracting model called a *competitively-selected alliance*. Under this methodology, two proponents are invited to work with the agency to negotiate a target cost. The logic is that by having an extra proponent in the contest for a longer period of time, the additional competitive tension helps to lower the agreed target cost. At the current stage in the development of alliance contracting as a form of project delivery in the public sector, it is difficult to assess the relative merits of the two models. ICAC advises agencies to be cautious about them both.

As noted above, when the risks are well managed alliance contracting can be a beneficial form of project delivery. The NSW Audit Office has published advice on the suitability of alliance contracting as a form of project delivery and recommends that it may be appropriate where one or more of the following characteristics are likely:⁴²

- The projects are complex and subject to significant internal and external change as they develop.
- The technology is state-of-the-art and involves research and development.
- External factors such as government regulations and the physical environment are likely to constrain management.
- Size (physical, human resources, financial) exceeds a previously established threshold for the industry, technology or enterprise.
- The project must interface and co-exist with an existing, operating facility.
- The project is aiming to set new benchmarks for early completion.
- The required works consist in whole or in part of maintenance or augmentation activities which can be improved and made more economical by integrating the owner and the contractor into one team.
- The client/owner does not require the price (or tender) to be market tested.
- The client/owner is prepared to enter into a risk-sharing arrangement where most risks are shared. In the event that the shared risk is capped by the other parties, the client/owner will need to be prepared to accept the cost of further downside risk.

⁴² Audit Office of NSW, 2003, *Sydney Water Corporation Northside Storage Tunnel Project—Performance Audit*, Audit Office of NSW, Sydney. Reproduced with the permission of the NSW Audit Office.

Given the purported advantages that alliance contracting offers in terms of project risk management and non-adversarial problem solving, there is a danger that the process can be misapplied and/or overused.

Managing the probity risks of an alliance contract will generally entail engaging a variety of independent advisers to assist with:

- facilitating the selection process (including workshops with proponents)
- examining the preferred proponent's accounts and performing due diligence
- an independent assessment of the target cost
- probity in general.

The formation stage of an alliance contract is typically highly resource-intensive for both staff and management of the agency. ICAC discourages agencies from entering into alliance contracts for projects that are too small to support the range of independent expertise that is needed to manage the probity risks involved in this form of contracting.

Case study – The RTA's Lawrence Hargrave Drive project

In August 2003, the RTA closed a section of Lawrence Hargrave Drive, north of Wollongong, because of rock falls. Because of the danger involved and the fact that closing the road would create a major disruption to local residents and businesses, it was decided that the project should be structured as an alliance. In addition, because of the complex engineering, geological and environmental issues, it was impractical to conduct a conventional bidding process.

After obtaining expressions of interest, the RTA invited five proponents to attend half-day workshops. Following this, two proponents were selected to attend an intensive two-day workshop, from which the preferred alliance partner was selected.

In order to maintain a degree of competitive tension, the remaining proponent was kept as a 'reserve' that could step in should final direct negotiations with the preferred proponent fail. A probity adviser oversaw the selection process.

In addition, a separate 'open book' audit was carried out on the preferred proponent's profit margins and cost assessments and an independent expert was engaged to calculate an objective 'should cost' estimate of the project. This provided assurance that the agreed target cost was not too high.

The RTA has estimated that using the alliance methodology has saved between nine and twelve months on the project's time frame.

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