



## The business case for lowest price tendering?

### Health Warning.

The use of lowest price tendering may seriously damage your financial health and reputation and may have undesirable and unexpected side effects.

Please consider the consequences.

# The pressure for lowest price

Organisations commence the procurement of a major project with a robust business case approved by senior management. This document has been prepared to assist organisations by identifying the key issues that they need to fully consider before deciding to appoint on the basis of lowest tender price alone. It outlines the perceived benefits associated with this procurement approach and highlights the controls that an organisation will need to have in place to mitigate the risks involved.

## Lowest price tendering as the preferred option

The preferred option of many organisations is the 'traditional working' process which they have always used involving sequential lowest price tendering. A sequential approach is where the Client engages consultant(s) to design the requirements followed by a separate procurement to appoint contractor(s) to undertake the construction without any integration of the teams. This procurement process has been around for hundreds of years, so everyone knows how it works and, because it is tried and tested, it's considered by those who adopt the approach to represent the peak of efficiency.

Some organisations consider this process to be the best option because, as they say below, why change to anything else?

- According to the National Audit Office,<sup>1</sup> one out of every four Government projects completed in the late 1990s was finished on time, and one in three was delivered within budget. Wouldn't changing to a different route risk reducing these odds that we have found acceptable for all these years?
- Change would mean losing the influence we, as client, are able to exert over a project. At the moment, we are able to define exactly what we want and then employ others to design and define component interaction and assembly before the contractors are appointed. It's accepted that few of us have ever actually built anything, but our designers have done lots of projects in the past so surely they can be relied on to know what works and what doesn't?
- Acknowledged, buildings are more complex now, and there is a lot more design associated with components and products with a much greater focus on whole life costs. However, there must be lots of things that have stayed constant over the same period of time so why change now?

Having worked through all this, we believe that most informed organisations should conclude that all this hassle is not worth the effort and that instead collaborative approaches that align the interests of the client and the supply chain will deliver lower and predictable outturn costs, on time, with fewer claims and management hassle, and of superior quality and long-term value.

- There is plenty of high profile examples of where the traditional process worked well. Take a look at Wembley Stadium. Accepted, there were some contractual issues along the way and the late completion meant a number of events had to be relocated, but what was actually built is really spectacular and you must admit that anyone who goes there is hugely impressed.
- Anyway, there will always be enough contingency money in the budget to cover any cost overruns, and sufficient slack in the programme to deal with any delays. If you are not convinced, just look back at all the jobs we finished last year!

## Other factors to consider

### The 'traditional' process is so simple.

- The client decides what they want.
- Only when they are needed, and not before, and on the basis of the lowest price offered, separately appoint:-
  - the consultants to do the design and produce the budget; and then
  - the contractors to do the work and appoint the specialist, trades and other suppliers.
- Once the price is agreed it's fixed unless there are changes.
- At the end all the disputes, claims, variations and extensions are settled and the final cost is derived (maybe with the help of the courts).
- Once it's finished it's handed over to the client (or others) to operate and maintain.
- There's a year's defects liability period when problems are resolved (if you can get them back).
- Depending on the contract form there is a further 6 or 12 years period where latent defects are resolved (if you can prove liability).

# Lowest price tendering: the reality!

The UK construction industry is in a downturn and, as a result, contractors are competing more and more aggressively to secure the relatively few new contracts that come to the market. Some poorly informed clients appear to consider this to be good news and are reverting to the practice of awarding contracts on the basis of the lowest tender price and are ignoring the associated risks and adverse consequences.

The real purpose of this note is to set out some of the problems associated with lowest price tendering and the reasons why clients must not repeat their past mistakes. In particular, it's key message is that lowest price tendering should not be used because:

- It forces contractors to price work at unrealistically low levels. As it is impossible to maintain standards and make profits, quality of work falls and contractors become more eager to engage in legal battles to recover their 'losses'.
- It does not deliver cost savings but in fact is more likely to result in cost and time overruns, leading ultimately to poor value for money and greater whole life costs in the maintenance and operation of assets.
- It attracts a high risk of abnormally low tenders which should be rejected under the provisions of the EU Procurement Regulations or the procuring authority faces a risk of challenge.
- It is against Government policy as set out by HMT<sup>3</sup> and the OGC<sup>4</sup>.

Over more than the last decade, a great deal of progress has been made in the public sector towards raising standards, achieving efficiencies and generally improving value for money throughout the whole life cycle of projects. Those involved with construction, are now seeing the tangible benefits delivered through collaborative working arrangements, including frameworks, partnering, and incentivised target cost contracts. Such benefits include higher quality products, better predictability of final cost and completion dates, with considerably less litigation in the process. For example, evidence suggests that 27% of projects now overrun compared to 77% in the mid 1990s and that collaborative projects are 15% more likely to be completed on time and 44% more likely to finish within budget than those let by 'historic' routes such as lowest price tendering<sup>2</sup>. Continuing with, or reverting to, a lowest price culture risks us all losing the considerable benefits that are now being gained from all these achievements over the last 10 to 15 years. Is this what you really want?

## This is the reality!

### Further information

Procuring in a Downturn. A guide for those procuring construction works during the current downturn who wish to obtain the best possible value from their investment [CBI October 2009]  
The benefits of collaborative procurement [National Improvement Efficiency Partnership June 2010]

## Other factors to consider

### What's really in a tender?

- the tender price on a construction project does not represent the final outturn price
- a low tender price which does not cover a contractor's costs will normally lead to the contractor seeking other ways, such as claims and disputes, to recover additional costs
- a fixed price, lump sum contract can still be subject to risks and claims which can result in the price increasing;
- passing risk to a contractor will attract a risk premium which may or may not represent good value for money;
- high value contracts which carry a high risk exposure are not generally attractive to the market and can result in a lack of competition; and
- the quality of the works provided or services delivered cannot be guaranteed if the monies reimbursed under the contract do not cover the costs of providing them.

# Benefits (perceived)

A review of the 'traditional' procurement process shows that there are several benefits that are perceived for both clients and the supply side .

## Benefits for the client

As a client you get to make all the important decisions and benefit from the resulting outcomes.

You can work out exactly what you want with the designers before any of the contractors interfere with the design. So when the project is finished you are responsible for how well it meets your business requirements.

Makes it easier when the client has to cut budgets in the short term

By always accepting the lowest price, the client is able to demonstrate it obtains good value with taxpayers' funds. This will be necessary when applying for new investment funds.

We always enter into 'fixed price' contracts and have total control over costs, so the room for contractors claiming extras is limited. If the contractor wants more money we will simply reject the claims by saying it was their risk. They will accept our decision because they won't want to upset the client.

The process is easy to audit as auditors only need to examine the tender opening sheet.

## Benefits for the supply side

If you can get away with being vague about what you are going to do, or are able to pass your responsibilities on to others, then you can make a good profit at the expense of others.

You simply have to focus on delivering what you are asked to do by the client. All clients make changes once a project is underway so there will be lots of opportunities for extras. Sometimes this is because their requirements weren't properly communicated at tender stage, or because the details provided are unbuildable. However, often it is simply because their needs have evolved over time and the current design is just not acceptable to them anymore. No matter what happens, you will not be blamed if the completed project is not what the client expected.

With all the worry about budgets you are bound to be asked to find alternative components, plant and equipment. This opens the door to cheaper products which probably are of lower quality and might not last very long, but they offer a higher margin for you. Therefore, so long as they get through the defects period the operating issues / costs / problems aren't your concern.

Tender prices may be insufficient to cover your cost of delivering the works, but don't worry because this can easily be recovered through the pursuit of claims and disputes once the contract has been secured.

Tender documents often contain errors, such as items identified in the specification that are not in the bills of quantities, or things shown on drawings which are not in the specification. This enables you to exclude them and submit a low tender price, and then when the mistake is discovered after the contract is let, negotiate prices at rates that are better than your tender price would have been. Keep the omission quiet for as long as possible, and hopefully until a long delivery gap has developed. Then you can claim more preliminaries for the extra time involved, and even use the additional time to catch up on any areas where you may have been responsible for the slippage.

Auditors only examine the tender opening sheet to ensure your tender is the lowest, and will never look closely at your tender submission to see if it represents value for money.

# Controls required to mitigate the risks

Clearly there are risks associated with 'traditional' lowest price tendering, but these can be managed by ensuring the following controls are in place for every contract:

Risk	Mitigation
Cost over run	The initial price is not the final outturn cost as contracts typically run over, so we need to allow an extra to our budget. We are currently working on how best to decide how much so, for now, add on the average overrun for your contracts last year (presuming you know what that is).
Time over run	Traditional contracts typically finish a bit later than planned, so we will have to add a few extra months to our programmes. We should be able to tell precisely how many extra months, providing there's no disagreement as to who is to blame, within a year or two of the job being finished.
Legal costs	The extra costs and delays will obviously have to be sorted out, so we had better make extra provisions for legal and QS fees. It's impossible to quantify how much though, so it's probably best to leave this until the job is finished and then weigh up whether it would actually be easier, in view of the magnitude of potential additional fees, to simply write off the disputed costs that have been incurred.
Legal challenge	We won't assess the quality of the bid because that increases the risk of a challenge. Also, if abnormally low tender bids are not rejected then there is a strong likelihood that we could be legally challenged by the unsuccessful contractors. We will therefore need to make sure we've got good lawyers on board and will have to add their potential fees to our budgets too.
Poor lifecycle performance	We will have to accept lower quality components in order to achieve our capital budgets, and this will increase our running and maintenance costs in the long term. However, future revenue budgets will hopefully be a lot higher than they are at the moment so we can easily deal with those extra costs later.
Cartels	Thanks to the OFT, we know cartels are reliant on a lowest price culture to be successful. Quality/price evaluation processes could prevent them at a stroke, but if we are to continue with traditional working then we'll have to address the dozen or so controls suggested by the OFT and HM Treasury instead.
Risk of insolvency	Uneconomic margins by our contractors may cause them to collapse, but there are plenty more of them available to complete our jobs.
Low morale	Our best staff may lose motivation and get fed up with arguing with contractors all the time and will look for jobs elsewhere. However, they will no doubt remain in contact, and be willing to spend some time with us later for nothing, as their experience and knowledge of the job will be invaluable should there be any disputes towards the end.
Damage to our reputation	OK we could get a bad name for treating our suppliers unfairly, and it might not align with our corporate social responsibility policy. But we won't suffer consequential financial loss, nor will it deter others from bidding for the next job.
No repeat business	If the project team does not perform as expected then there is always the option never to select them again. Unless they submit the lowest price for the next job, of course!

## Where to go next

### [constructingexcellence.org.uk](http://constructingexcellence.org.uk)

The Constructing Excellence website is an excellent source of guidance and case studies from over ten years of practical application of collaborative working techniques. Members of Constructing Excellence have privileged access to a full set of how-to tools and training packages to support a change programme.

### [Constructing Excellence regional centres and local best practice clubs](#)

This network is a valuable source of regional information and knowledge as well as networking opportunities with like-minded people from the sector who wish to explore collaborative working opportunities.

See [constructingexcellence.org.uk/regionsclubs.jsp](http://constructingexcellence.org.uk/regionsclubs.jsp).

### [cecwchampions.co.uk](http://cecwchampions.co.uk)

The Constructing Excellence Collaborative Working Champions meet regularly to share experiences and to mentor those looking for support. Many have been implementing and promoting collaborative principles for well over ten years, and collectively they draw on some 500 years of construction industry experience. The Champions have created an online network for people interested in learning about and promoting integrated collaborative working in the built environment. It is an open group, welcoming industry participants from all backgrounds including client organisations, contractors, consultants, materials suppliers and manufacturers, facilities managers, academics and students.

**CIPFA** is the leading professional accountancy body for public services, whether in the public or private sectors. It provides education and training in accountancy and financial management, and sets and monitors professional standards. CIPFA's professional qualification is high-quality, relevant and practical, and is supported by a range of other products and services. We are a major publisher of guidance for practitioners and others with an interest in the public services.

**Constructing Excellence** is the leading think tank and best practice organisation in the UK built environment sector. Its core funding members include clients, contractors, consultants, specialists and suppliers across the buildings and estates, infrastructure and housing sectors. Our core themes include collaborative working, sustainability and value, and our evidence-based approach uses action research, innovation, demonstration, measurement, networking, guidance and influence.

#### References

1. Modernising Construction, National Audit Office, 2001
2. Don't risk the historic approach, Be, 2004
3. In 2007, HM Treasury published "Transforming Government Procurement" which states that the Government needs to attract people who understand that good procurement is not just about driving down contract costs and who do not retreat to the lowest price solution simply because it appears at first sight to be the most easily defensible.
4. The key thrust of OGC's "Achieving Excellence in Construction", which is mandatory for central government construction procurers, is the delivery of value for money. The guidance sets out that this is not lowest cost but the optimum combination of whole-life cost and quality to meet the user's requirements.

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