

# 10 Contracting out and market testing

## **Contracting-out policy**

10.1. BWB stated that contracting out gave it the ability to switch on and off work very quickly to redirect effort to suit revised priorities, which, it claimed, could not be done with direct in-house labour. Following the 1987 MMC report, it has taken the view that the importance of flexibility is overriding such that even when the contract cost of a job is equivalent to the direct labour cost the work should be contracted out. We were told that, in the past, lack of flexibility had been the cause of time-wasting and inappropriate use of skilled direct labour, especially during the summer period, which had given rise to much criticism of BWB's direct labour waterway staff by boaters and riparian landowners. Large reductions in waterway wages grade staff and the introduction of multiskilling in recent years had improved efficiency and effectiveness at the waterway level, and, we found, has improved the reputation of BWB among canal users.

10.2. BWB conceded that there was no formal headquarters policy as such on contracting out. Nor were there formal targets for a certain percentage of work to be contracted out, although it stated that pressure was applied on managers to contract out as much as they possibly could. It was of course necessary to retain core staff with specialist skills for emergency work and for control, monitoring and safety: the number of such staff retained was for local management decision at regional and waterway level. BWB further explained that while there is currently no formal statement on contracting out, a policy to reduce its long-term costs to the maximum extent possible, consistent with standards and flexibility, was apparent in waterways plans. As a result its general practice was that major works were generally completed by outside contract using its competitive tendering procedure, whereas day-to-day maintenance and operation of the waterways was a mix of direct labour and contract. We noted that UNISON believed that a considerable amount of work was being contracted out when an in-house team could and should be able to undertake this work efficiently and more cheaply. In its view, the problem lay in the fact that BWB had reduced its workforce below that which could reasonably be seen as an optimum level and added that BWB's budgetary systems tend to pressurize managers into contracting out rather than doing work internally.

10.3. In respect of both major works and minor or routine maintenance, BWB told us that the criteria for assessing whether a job should be performed by direct labour or contracted out covered a range of elements, some of which would be:

- (a) value for money;
- (b) sufficient availability of skills external to BWB to allow competitive tendering;
- (c) flexibility;
- (d) customer service requirements and interaction with the public;
- (e) retention of long-term knowledge and understanding on a length of waterway; and
- (f) service standards.

Examples provided by BWB of contract work on a large waterway (Trent & Mersey) and on a small waterway (Worcester & Birmingham) covering both major works and minor or routine works are given in Appendix 10.1.

10.4. The 1987 MMC report recommended that BWB should produce a formal statement of its contracting-out policy, and further commented that after BWB had obtained reliable in-house cost data, sound decisions could be made on whether to do the work internally or to use contractors or consultants. As noted above, there is no formal policy statement as such at present, although a 'market testing' policy that BWB began drafting during our inquiry may go some way towards meeting the recommendation for a document on contracting out and in which market testing can be included as a particular aspect. The expression 'market testing' is not used by BWB strictly as defined within central guidance. The nature and extent of BWB's market testing is dealt with in detail later in paragraphs 10.28 to 10.46.

## **Contracting-out procedures**

10.5. The Anchor Lock case study (see Appendix 11.17) gives a detailed description of a major project, the refurbishment of a lock, in which the most of the works were contracted out. BWB advised us that, in 1992/93, 90 per cent<sup>1</sup> in value of all major projects (effectively all projects with a value of more than £20,000), and 45 per cent of non-major or routine waterway maintenance were contracted out. The 1993 Corporate Plan stated that the overall percentage of contract expenditure to total direct waterway expenditure had increased from 22 per cent in 1987/88 to 45 per cent in 1992/93 and is planned to reach 50 per cent in 1995/96. In many cases BWB has no option but to contract out because the relevant skills and facilities are no longer possessed in-house: in this situation market testing cannot, by definition, be carried out and BWB has to fall back on the evaluation and comparison of submissions received in answer to its invitations to tender. There have been instances where BWB has not been fully satisfied that it was getting truly competitive tenders.

10.6. BWB summarized its overall process for contracting out a major work as:

- (a) identification and quantification of work to be done;
- (b) seeking and gaining authorization for expenditure;
- (c) design specification and tender documentation;
- (d) invitation to tender to approved contractors;
- (e) receipt of tenders, assessment and decision;
- (f) contract issued and pre-work meetings held;
- (g) supervision and monitoring of work by contractor;
- (h) completion of project and acceptance by BWB; and
- (i) formal post-project audit or Engineer's report.

The diagram included in BWB's 1993 Corporate Plan showing the procedure for the initial part of this process, from the specification of objectives and standards to the decision to contract out or retain in house, is shown in Appendix 10.2.

10.7. Detailed instructions on Contract Administration Procedure are issued by BWB's Engineering Department. There are nine sets of Standard Conditions of Contract listed by BWB covering a range of activities from civil engineering construction to minor works although not all of these are currently in operation. The nine sets are:

- (a) Civil Engineering Construction;
- (b) Mechanical and Electrical;

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<sup>1</sup>The remaining 10 per cent comprises specialist tasks such as lock gate fitting, operating mechanisms and similar works mainly in the North East Region.

- (c) Marine Engineering;
- (d) Ground Investigations;
- (e) Hydrographic Surveys;
- (f) Topographical Surveys;
- (g) Ground Maintenance Works;
- (h) Minor Works; and
- (i) Design and Build.

Dredging is covered under Civil Engineering. BWB told us that the Design and Build contract has been used for the supply of certain bridges.

10.8. The respective Contract Administration Procedures vary in length and complexity with the extent and nature of the contract to be performed. For example, the Civil Engineering Construction version runs to 80 pages, divided into seven sections:

- (a) Invitation and Receipt of Tenders;
- (b) Acceptance of Tender;
- (c) Contract Delegations and Documents;
- (d) Head Office Attendance to Site Work;
- (e) Site Procedures;
- (f) Health and Safety at Work; and
- (g) General Guidance to Engineer's Representative on Site.

Included in the procedures are 28 Technical Services Forms dealing with all aspects of contract procedure from the recommendation of contractors to whom the invitation to tender may be sent (usually a minimum of six), which is issued either by the Head of Technical Services or by the Regional Engineering Manager, through tender analysis and acceptance to approval of works, evaluation of contract, the weekly site report and the Engineer's Final Certificate. The procedure defines 'The Engineer' as the Head of Technical Services or the Regional Engineering Manager, who 'delegates all those Clauses of the Contract which he can to the Delegated Engineer who may have a Project Engineer responsible for the day-to-day administration of the Contract'.

10.9. The task of the 'Engineer's Representative' (ER) on site is to assist in making sure that the work is being carried out in accordance with the Specification and Drawings which themselves have to be completed, approved and expenditure authorized at the required seniority level before any invitations to tender for any part of the project are sent out. It is stated in the Guidance Notes that the ER 'should try to anticipate difficulties likely to occur, either because of the general behaviour of the contractor or because of misleading information on the Drawings or in the Specification'. Furthermore the ER is instructed 'to assist the contractor in every way possible within the terms of his responsibilities, despite the fact that during the course of the work disagreements may occur between himself and the contractor's representative'. It is open to question as to how much this 'assistance' costs BWB and whether the contractor should be charged for it.

10.10. The procedure for the selection of contractors is shown in diagrammatic form in Appendix 10.3. The list of approved contractors is maintained by the central Engineering Technical Services function. It is regularly updated by the Chief Civil Engineer, taking into account past performance on BWB contracts. Potential contractors seeking listing for the first time are subjected to a vetting procedure which includes taking up references, both technical and financial, evaluation of previous experience, assessment of financial security,

questioning on safety performance, and will involve face-to-face interviews to examine these and any other relevant matters.

10.11. There is a strict procedure for opening and acceptance of tenders. Opening is carried out by a senior member of BWB staff not directly involved with the project. It is the responsibility of the Project Engineer to have all tenders analysed and checked: clarification from a tenderer may only be obtained by means of a letter. A tender report is prepared including all revisions and analyses, making a clear recommendation for the appointment of a contractor, together with the Acceptance of Tender document signed by the Project Engineer and countersigned by the Head of Technical Services or the Regional Engineering Manager. All documents with the exception of the actual tenders are forwarded to the Project Manager who, after reviewing them and the recommended contingencies, will either authorize or recommend for authorization the Acceptance of Tender depending on the value of the project to which the tender relates. Tenders in excess of £100,000 are also considered by Head Office, and those between £200,000 and £500,000 by the Executive Group. Projects in excess of £500,000 require Board approval and require a Director to be present at the tender opening.

10.12. In respect of default on contract and indemnification against loss, BWB includes a general provision in its civil engineering contracts for liquidated damages as set out in the Institution of Civil Engineers Conditions of Contract (fifth edition) which is included as an appendix to the formal offer in the contract documentation. BWB advised us that this effectively covered situations such as the need to crane boats around a lock which had not been reopened at the scheduled time due to overrun by the contractor: however, we were told that contractors also raise counter claims. It is debatable as to whether this arrangement provides adequate recompense for the cost and inconvenience suffered by BWB and users, or that it is sufficiently robust to impress contractors; the use of more focused sanctions in the management and control of BWB's contractors may be advantageous.

10.13. At the other end of the scale the contracts for minor works and routine maintenance take the form of the Institution of Civil Engineers standard form of contract for Minor Works, or quotation against a written specification, or a purchase order specifying to a greater or lesser extent the work required if the value is less than £10,000. Contracting out for expenditure below £20,000 is at the discretion of the Waterway Manager who may also action contracts between this level and £100,000 with the permission of the Regional Manager. The procedure is less comprehensive than that for major works as would be expected.

10.14. Project Managers are responsible for ensuring that projects are reviewed following completion. Checking and signing-off on a standard form will normally suffice for projects under £500,000 unless there is a significant (10 per cent) variation from original authorization. In the latter case, and for all projects above this figure, a post-project appraisal must be completed. Post-project appraisal of schemes over £500,000 are submitted to the Board. Interim reports may be required if the project lasts for more than one year.

## **Cost-effectiveness of contracting out**

10.15. BWB told us that, over the past few years, it has been moving more and more to contracting out. It agreed that there is an increased cost of supervising the contractors, but also claimed that the time spent supervising a contractor was less than it would have spent managing its own in-house workforce. It described the situation as follows: 'We write a good specification, hand it over to the contractor after we have been through the appropriate tender procedures, and then just measure the output', adding that 'as long as the service met the standards, whatever it was asking for, then that was sufficient'.

10.16. It is not clear how the cost-effectiveness of hiring a contractor is calculated in the absence of an in-house baseline, nor how checks are made to ensure that there has been no collusion between contractors. We were told of one case where collusion between farmers in respect of a grass-cutting contract resulted in the job being brought back in-house, but clearly this is not an option for the larger jobs where significant numbers of the relevant staff have been disbanded and the equipment disposed of. With these considerations in mind the near-complete contracting out of major works may not necessarily represent the most cost-effective approach if there is total reliance on 'competitive' tendering figures with no ability to have an in-house comparison. BWB told us that it had considerable knowledge of market prices and would reject all bids if it considered the level too high.

10.17. BWB told us that, particularly in the case of large river structures, it was not infrequently the case that contractors remained at the bottom of the learning curve as regards waterway work. This was because it was not common for any one contractor to secure a further major works contract in the short or medium term because of

BWB's preference to select a contractor from a geographical location at or near a given site who, it said, tended to give the competitive price. Under these circumstances, close and constant supervision is essential to ensure that an acceptable job of the required quality is achieved and this may negate any cost savings ostensibly achieved by contracting out. The Anchor Lock refurbishment work, cited earlier, clearly illustrates the comprehensive and entirely appropriate control procedures in place for a major work on a canal and the close supervision by BWB project staff. At the other end of the scale we were told that the supervision of contracted-out agricultural works had been 'a nightmare' and had cost much management time to obtain even a less than satisfactory performance. BWB denied that management decisions had been influenced by the desire to show that an increasing proportion of the annual works had been contracted out thus reducing in-house labour.

10.18. Although BWB engineers are prepared to guide and counsel potential or actual contractors in waterway structure requirements and practices, there may not be much enthusiasm to take this up by contractors. For example, we were told of one case where a contractor was only prepared to spend time with BWB to understand the problems and to learn the techniques involved in waterway structures (in this case bridge mechanization) if BWB paid the contractor for that time.

## **Contracting out of property services**

10.19. BWB told us that it considered that it did contract out its property business and the development of its estate. It pointed out that while it managed the assets, the actual development was done by the private sector and in some cases by the local authority. Nevertheless, it was stressed that BWB was an active partner with developers in that it brought to the developer knowledge of the waterway, the relevant engineering and the leisure and tourism possibilities (see Chapter 9).

## **Benefits of BWB procedures**

10.20. BWB's Corporate Plan 1993 states:

Market testing has been carried out over a number of years with contractors and consultants being employed to do certain aspects of the work. All major works have been contracted out for many years.

10.21. In addition a policy paper approved by the Board (and explained in paragraph 10.28) states that the benefits from outsourcing have been marked and BWB is keen to ensure that all parts of the organization benefit.

10.22. We asked to see some quantification of the benefits of market testing and of the outsourcing mentioned by BWB. BWB quoted, by way of example, benefits which had accrued to the North West Region. They were:

- (a) Work undertaken in-house had reduced from 80 per cent in 1989 to 50 per cent in 1993.
- (b) BWB's income per employee had risen to £16,500 from £8,000 in the same period. This was the result of using internal expertise and reducing the number of employees, and was not at the expense of reduced quality.
- (c) The direct waterway cost per km would have been £15,000 if no management improvements had taken place within that period. In the event it was £11,000.
- (d) Actual income over the three years to April 1992 (for which out-turn figures were available) had risen 30 per cent.

10.23. Our view was that none of these pieces of evidence, whilst indicative of progress, actually showed what was attributable to either market testing or to putting work out to tender. It also appeared to us that in claiming to having undertaken market testing over a number of years, BWB may have misinterpreted central guidance (this is discussed below). We therefore asked, early on in our inquiry, for BWB's record of cash benefits from market testing and/or putting work out to tender over the previous four years. BWB was unable to provide such a record.

10.24. Later on we wrote to BWB with a series of questions. Amongst them, in pursuit of the question originally posed, was one asking for the cash benefits from market testing and putting work out to tender over the past four years. In particular we asked for the benefits from market testing of particular functions, ie of putting out to tender and allowing an internal capability to compete.

10.25. BWB's reply was that market testing as a formal, fully documented process had not been carried out on a BWB-wide basis in the past.

10.26. BWB also replied that evidence of the benefits of market testing was shown in the financial and operational figures reproduced here as Table 10.1.

TABLE 10.1 Selected financial and operational figures

	1990/91	1991/92	1992/93
Direct waterway costs (£m) (exc arrears)	34.8	34.6	35.6
Cost per km (out-turn prices) (£)	10,740	10,686	10,994
Cost per km (1992/93 prices) (£)	11,578	11,070	10,994
% change from 1990/91		-4.4	-5.0
Waterway standards			
% at Nav 2 standard	-	40	43
% change from 1991/92			7.5
% at environ A standard	-	45	51
% change from 1991/92			13.3

Source: BWB.

10.27. Again, our view was that this general information did not actually identify improvements attributable to market testing.

## Market testing policy

10.28. BWB has a Working Group on Market Testing. On 30 March 1993 the Board considered a policy paper, already mentioned, entitled *Market Testing in British Waterways*. It specifies the procedure that BWB intends to follow in market testing and the Board minutes show that the Board endorsed the policy contained in the paper.

## Market testing procedures

10.29. The Corporate Plan contains the flow diagram mentioned in paragraph 10.6 above and shown at Appendix 10.2. The same diagram is shown in *Market Testing in British Waterways*. In each case it is referred to as BWB's market testing procedure. It is significant that the preparation of an in-house bid is nowhere mentioned.

10.30. In November 1991 a White Paper *Competing for Quality*, Cm 1730, was presented to Parliament. One of its proposals was the setting of targets by Government departments and Executive Agencies for testing new areas of activity in the market, to see if alternative sources give better service and value for money. Another proposal was the setting up of a new Public Competition and Purchasing Unit to promote the programmes set out in the White Paper.

10.31. In March 1992 the Public Competition and Purchasing Unit published a document *Guidance Note No 34, Market Testing and Buying In*. The document contains a flow diagram illustrating the key stages in the market testing process, and we reproduce it here as Figure 10.1.

10.32. An essential feature of the market testing process is the preparation of an in-house bid as shown in the diagram at the centre of the Competition Phase.

10.33. We present here two examples which BWB believes constitute market testing. The first has no internal tender element, whereas the second does.

## **Pension administration**

10.34. The report *Market Testing in British Waterways* states that the Pension Administration function has been market tested. We were told that consultants were engaged by BWB to do this and we examined their report dated 10 November 1992.

10.35. The objectives of the review, as set out in the report, did not mention market testing at all but included the following:

- (a) to provide a bench-mark against which cost comparisons with other future options could be made; and
- (b) to provide outline cost comparison and cost projections between the most viable future options, in particular: retain full in-house administration; partial subcontracting; full subcontracting.

10.36. The consultants' conclusions ran:

This review has highlighted that the British Waterways pensions department provide a high quality and professional service. Given the level of in-house pension expertise, we consider that British Waterways should retain administration in-house. There is scope to reduce costs and enhance efficiency.

## **Bulholme Lock**

10.37. Tenders for the reconstruction by sheet steel piling of the south bank upstream of Bulholme Lock on the Aire & Calder Navigation were invited for return to BWB by 20 November 1992. We have examined the documentation and it is clear that in this case an internal bid was placed and properly judged following tender opening along with six other bids. It happens that BWB won this bid, but that is not the important point in the present context.

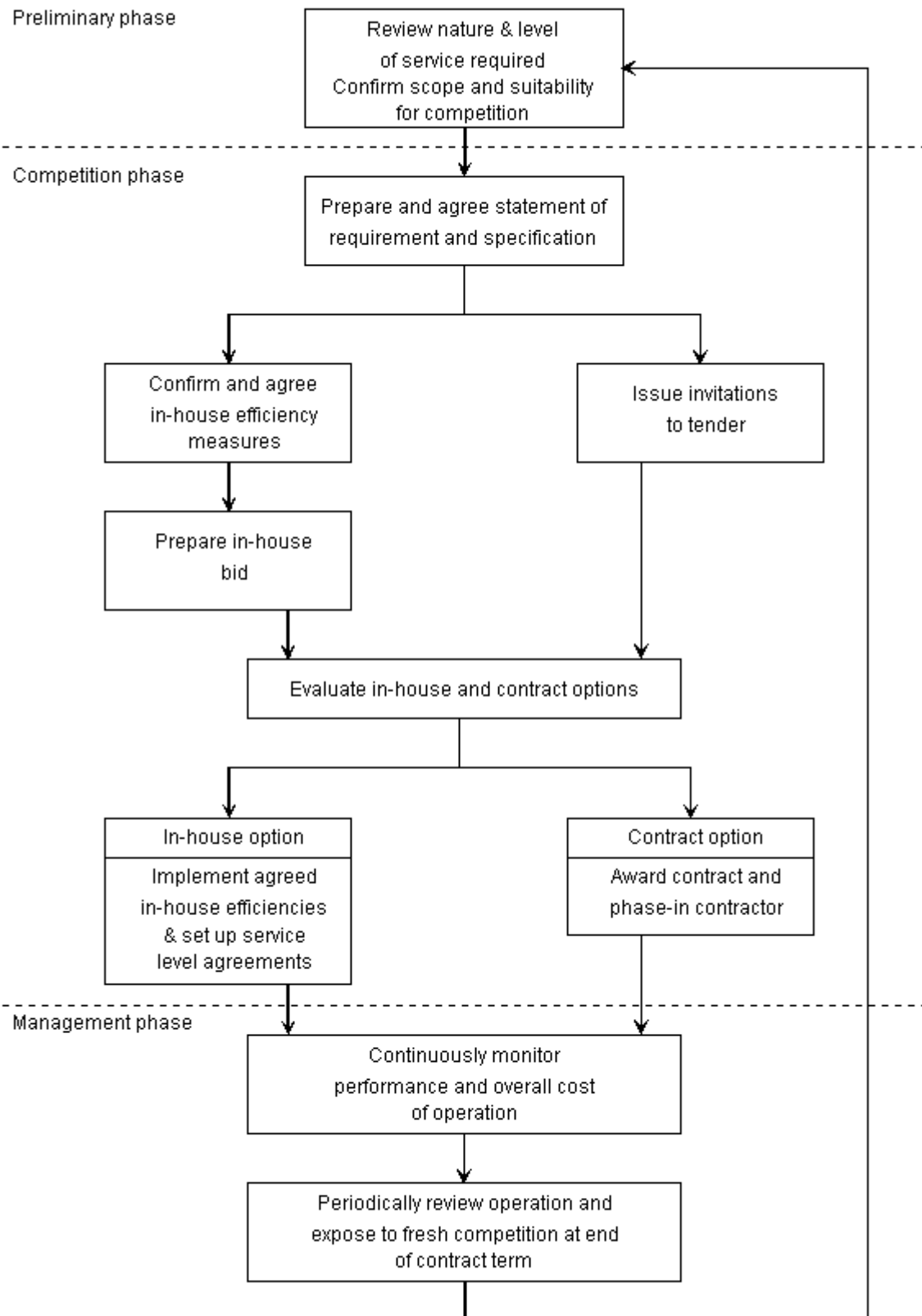
## **Interpretation**

10.38. The case of Bulholme Lock with its internal bid contrasts with that of Pension Administration where there was none. The Bulholme Lock process conformed with market testing guidance whereas the Pension Administration process is more accurately regarded as bench-marking.

10.39. We asked BWB whether we should conclude that there was a misconception within it of the arrangements for market testing advocated by central guidance and whether, as a result, BWB had failed to make full cost comparisons of in-house bids against those obtained from external sources.

FIGURE 10.1

Typical example of market testing



Source: PCPU Guidance no 34, Market Testing and Buying In.

The response was that BWB had no misconception about market testing, that BWB would ensure that all aspects of the organization would be subject to it and that in-house costs would be fairly assessed using a full cost comparison with external contractor bids.

10.40. We asked BWB whether the Transfer of Undertakings (Protection of Employment Regulations) 1981 (TUPE) would affect its market testing and contracting out. TUPE protects the rights of employees when their employer's business or the undertaking in which they are employed changes hands. BWB replied that market testing and contracting out in the form it currently envisaged would not be relevant transfers for the purposes of TUPE.

### **BWB's plans for market testing**

10.41. The Corporate Plan for 1993/94 to 1996/97 states that BWB will be expanding its programme of market testing. The plan is for a variety of areas of work involving 500 jobs to be market tested by 1995/96. This plan is, of course, based on BWB's own interpretation of market testing.

10.42. Apart from the examples already mentioned, we examined two of the support services provided by BWB staff to operational management as discrete areas of work which may have had the potential for contracting out. These were payroll administration and computer support.

10.43. The budget for payroll administration in 1992/93 is £192,000. BWB told us that it intends to market test the function later in 1993 and preliminary discussions have been held to determine availability of services from private sector payroll bureaux. The payroll section is also responsible for the maintenance of personnel records which would probably be retained in-house should an external agency assume responsibility for payroll administration.

10.44. The MIS budget for 1993/94 is £1.2 million which includes £680,000 in salary costs. The department supports 50 offices, 500 computers, ten local area networks, one wide area network and 25 applications plus associated operating systems. The 1987 MMC report recommended a strengthening of the department which in 1987 consisted of 29 staff. Despite added responsibilities the staffing level has been reduced to 20.

10.45. We noted BWB's intention to market test MIS in the near future. We were told that the need for a team of permanent core staff, with knowledge of the systems and the business, was fundamental to the support of its large user base. Contract staff are used for particular projects when the requirements of the users can clearly be defined in advance and where specific knowledge of the business is not required. PC hardware maintenance is undertaken by external contractors as expertise is not available in-house for this function.

10.46. A list of areas to be market tested during 1993/94 was presented to the Board by the Director of Finance in April 1993. This is shown at Appendix 10.4.

### **Conclusions and recommendations**

10.47. We found the BWB contract procedures for major works to be comprehensive and thorough with a clear method and formal documentation for progressing and administering them. The levels of authority and delegation are set out and the levels of approval and authorization stipulated. Examples of contracts inspected during the inquiry demonstrated that the procedures are applied and followed through.

10.48. We conclude that, as BWB has contracted out some 90 per cent of its major works already, there is little scope for further contracting out of such works, with the exception of dredging (see Chapter 11). In respect of non-major or routine maintenance work, of which 45 per cent is now contracted out, care must be taken to ensure that contracts are truly competitive and core skills are not reduced to inadequate levels for safety, control, monitoring and specialist tasks.

10.49. BWB's experience in contracting out routine works or minor repairs is that cost-effectiveness has been variable, particularly in cases where strict and frequent supervision of contractors carrying out relatively low-

value tasks has been required. We conclude that contracting out has reached and possibly exceeded the limits of cost-effectiveness in some cases.

10.50. We conclude that there is a misconception within BWB of the arrangements for market testing advocated by central guidance and that as a result BWB has not made full cost comparisons of in-house bids against those obtained from external sources.

10.51. BWB intends to market test a number of support functions including payroll administration, credit control and aspects of IT with a view to contracting out if appropriate. There is, however, a misconception within BWB of the arrangements for market testing advocated by central guidance and as a result BWB has failed to make full cost comparisons of in-house bids against those obtained from external sources.

10.52. We recommend that BWB should:

- (a) assess the *overall* cost-effectiveness of contracting out ongoing and non-major maintenance works more rigorously and on a comparative basis with in-house tenders;
- (b) develop and install a procedure by which rapid comparative assessments of tenders may be made for direct use by all Waterway Managers;
- (c) investigate wider and more vigorous use of penalty clauses instead of provision for liquidated damages in its contracts; and
- (d) carry out formal post-project audits on a random selection of smaller projects.

10.53. We recommend that BWB should by 1 January 1994 implement, where appropriate, proper market testing procedures including full cost comparison of in-house bids against those obtained from external sources. Where there is difficulty in obtaining competitive external bids and BWB has not retained the internal capacity to carry out the work, BWB should calculate theoretical internal costs as a check on tender prices.