

Procurement & Tendering by Dutch Municipalities

Dissertation Summary

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Summary

Over the last decade the relationships and interactions between municipalities and civil engineering contractors have become a delicate matter. New visions on the task and functioning of public agencies have emerged, more attention is drawn to fairness of public conduct and to the integrity of civil servants, and last but not least the appreciation of the coordinating role of the marketplace has increased. This has resulted in policies for privatisation, which state intentions of less government and more market, in initiatives for reducing and slimming public agencies, and in attempts for making these agencies operate in a more businesslike way. These developments, supplemented by the introduction of the EU procurement directives, have compelled politicians and policy makers to take more interest in the procurement of civil engineering works, and made them more critical towards the current procurement practice of municipalities.

In the debate on what would be the best tendering and procurement practices, a controversy arose. In a decade of growing faith in the functioning of markets, the municipalities appeared to greatly prefer commissioning the works to a limited number of contractors. In the period between 1991 and 1993 over 65 percent of the projects, which equals 45 percent of turn-over, was commissioned after negotiation with a single contractor. Public tender procedures were seldom used (in 7% of projects; 17% of turn-over). Of all public agencies the municipalities scored the lowest on percentage of work procured through public tendering procedure. For the politicians and policy makers who plead for more use of the market, these figures were hard to understand and to explain. So, the municipality officials had some explaining to do on matters of procurement, and on their relationships and interactions with civil engineering contractors: *Given the benefits of the market, why is the public tendering procedure so deliberately avoided by the municipalities?* The research described in this book is focused on that question.

This question was approached from three mainstream theories, the rational contingency paradigm, the transaction cost economics paradigm and the network paradigm, which represent subsequently: coordination through hierarchy, market and network. Since procurement and tendering concern contracting problems, the transaction cost economics paradigm (TCE) proved to be the best suited for the description and analysis of this procurement problem. The characteristics of the construction market fit well to the TCE framework (as given by Williamson 1985). TCE acknowledges that in *make or buy* decisions production costs are not the only costs to be considered.

Contracting out introduces all kinds of transaction costs. These are costs made in order to find a contract party, to reach an agreement, to draft a contract, and costs to enforce the contract. Furthermore there are risks involved. What if the contract turns out to be imperfect, or if the specifications have to be changed? In such cases elements of the original agreement have to be renegotiated. This renegotiating differs from negotiation in the pre-contract period because the post-contract renegotiation takes place in a *small numbers* bidding situation. An ill fated (devious) contractor may exploit this situation (in TCE terms this is called *opportunistic* behaviour). Knowing he is the only person with whom negotiations are conducted, he can assess the cost and problems the client will have to bear in case the original agreement is terminated during construction. This puts the contractor in a strong bargaining position. Correcting contract imperfections or effecting change orders may come dear. Another risk for the client is formed by the so-called *hit and run* tactics, which happens when a contractor chooses to discard the contract terms, cuts corners, expecting this malpractice stays uncovered until he has collected his fee, and is out of reach (another appearance of *opportunistic* behavior).

So, the contract is not the final product. If all seems well at the closing of a contract, then that doesn't mean for certain that all will go well during execution of the contract.

Now back to the procurement controversy. Conducted interviews showed that practitioners, the officials of municipalities, are very much aware of the transaction costs, and of the uncertainties and risks hidden in the use of contracts. Their main concern is project control and therefore control over the contractors' *opportunistic* behavior. Field investigation further showed the use of a mechanism to control this opportunistic behavior: The client directed the contractors' view, beyond project delivery, towards the future. If the contractor delivered good quality work, showed a professional attitude and flexible co-operation, he would be considered as a potential candidate for future projects. This mechanism was predicted by the TCE framework as a *safeguard*: "*introduce trading regularities that support and signal continuity intentions*" [Williamson 1985:34]. These signals are expected to reduce the tendency to opportunistic behavior, because such behaviour may induce an end to a presupposed continuous trading/business relationship (you might lose a client). Proverbially spoken: It seemed clients steered contractors through the projects by using future projects as carrots, instead of using the threat of legal repercussions as sticks. By using this mecha-

nism the municipalities were able to reduce the uncertainties and risks inherent in contracting out situations. The contractors, aware of the clients' memory, are driven to do more than just fulfil the contracts' specifications. Since the client recollects former experiences with contractors before procuring and commissioning new projects, it pays the contractor to put in some extra effort. The primary contractors' objective shifts from fulfilling the contract to satisfying the client. So, through this mechanism the municipalities are more in control than without it.

The described mechanism has strong implications for the selection of tendering procedures. Public tendering procedures depend on the market for selecting a contractor. Normally, price competition decides which contender gets the job. Public tendering has no memory. It is unaware of contractors' performance on past projects. For rewarding a good job with new work, the specific selection of contractors must be in the hands of the client himself. The safe guarding mechanism requires the client to be in control of the selection of the contractor, otherwise the carrot will not be convincing. This is best established by the negotiated tender procedure. Broad utilisation of the mechanism must lead to a construction market dominated by negotiated tendering procedures.

Intermezzo: Why not use tendering procedures in which the client pre-selects a small number of qualified contractors, and then exercises price competition to make the final decision? In that case you use the safeguarding mechanism as well as the market mechanism. The answer is that this competition between a selected set of contenders, may turn out to be no competition at all. The main thought behind the market mechanism as a price reducing mechanism is based on the assumption of large numbers competition. Small numbers competition may induce price agreements. The competitors set prices high and divide the workload. In such cases there is nothing the client can do, he cannot negotiate, has to accept the lowest bid, and to commission the work. So instead of being better off by using both mechanisms, the client can only hope and pray that the competitors don't succeed in reaching an agreement between themselves. Here neither the market, nor the client is in control. This enforced competition between selecting contenders might be the most fallible tendering procedure.

When the utilisation of the safeguarding mechanism induces a situation in which negotiated tender procedures are favoured and work is repeatedly commissioned to familiar contractors, a pattern of recurrent transactions emerges. The interactions and relationships of clients and contractors becomes more continuous, more stable and more exclusive. Now we are in the realm of the network paradigm; accordingly the research was re-directed to look more closely into client-contractor interactions to seek and evaluate network characteristics.

So, the first field investigations, and the matching of the findings with the transaction cost economics

paradigm, resulted in a perspective which can be summarised in three statements:

- the building process is performed by a temporary coalition organisation (inevitably, given the characteristics of products and the structure of the construction industry);
- contracting out introduces uncertainties and risks (esp. risks of opportunism);
- risks are reduced by commissioning projects to familiar contractors (into the network realm).

This perspective functioned as the theoretical backbone for the design of the empirical research. The following research activities were performed:

- survey into the expectations on privatisation and the contracting out of design activities (questionnaires were sent to 230 municipalities, 89 responded);
- in depth interviews of municipality officials and contractors officials;
- survey into the contractors appreciation of continuity in relationships, evaluating their sensitivity for the safeguarding mechanism (35 structured interviews);
- survey into client-contractor co-operation during project execution: for the evaluation network characteristic of the interaction, and the links between performance and probability of future project commissioning; clients' as well as contractors' view (117 projects evaluated);
- survey into the application and effectiveness of the uncovered safeguarding mechanism, through investigating the corrective/repressive utilisation of the mechanism; i.e. signalling expected termination of presupposed continuity in a business relationship as a warning (50 structured interviews of municipality officials).

The results of the study show the problematic nature of the construction market, and the strategies adopted by the municipalities to overcome this problem. The data gathered by the empirical research supported the assumption on the use of the safe guarding mechanism. In their effort to gain more control over separate projects, municipalities choose to reward the performance of the contractors and their flexibility with new assignments. Therefore they prefer the private tendering procedures, and avoid the open public tendering procedures. Subsequently recurrent transactions alter the relationships between the municipalities and contractors from just ad-hoc contracting parties towards *co-makership*.

Furthermore, the outcome of this study raises questions about the adequacy of the European procurement directives, especially about the emphasis on open public tendering combined with price competition. It appears that the underlying views on the functioning of markets are more idealistic than realistic. The directives ignore the problematical nature of transactions in the field of construction and building, and disregard the value of the procurement (tendering) selection as an effective tool in project control.