Guide to Maintain or Enhance Value for Money

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What is value for money?

Value for money (VFM) is the achievement of a desired procurement outcome at the best possible price, not necessarily the lowest price – based on a balanced judgement of financial and non-financial factors relevant to procurement.

VFM takes into account the total cost of procurement from planning to disposal and all the steps in between. This is commonly known as Total Cost of Ownership (TCO). The first section of these guidelines concentrates on the term Total Cost of Ownership.

When to access the TCO?

It is important to identify the cost of ownership at an early stage in the procurement process. Otherwise, it can result in a flawed assessment of value for money and the organisation will incur unnecessary expense.

TCO assessment is essential to understand the true costs of long life, complex procurements. However, there is generally little benefit in undertaking a detailed formal assessment for short-life, low cost items, especially when comparing them with other well-known and equally simple options.

TCO assessments are particularly important when comparing lease or buy alternatives. TCO is also important when considering low initial price goods/services and high ongoing cost versus high initial price and low ongoing costs goods/services.

Considering TCO during the market analysis stage can identify opportunities to leverage competition and market dynamics, promote productivity and to the identification of innovations in the market.

It is also worth considering TCO at later stages of the procurement process, such as contract management to drive continuous improvement during the contract period.

Calculating the Total cost of ownership

Calculating the TCO includes a 'whole of lifecycle' analysis. A common-sense approach is needed when determining the extent and method of the 'whole of lifecycle' costing assessment. There is no one formula that covers all circumstances. In many cases calculating whole-of-life costs will be a simple and straightforward process as the total costs and benefits of ownership will be apparent.

However, a formal evaluation should be used when comparing options with noticeably different initial price and other differing features, such as:

- Technical and performance features
- Life expectancy
- Ongoing costs
- Residual value
- Disposal costs

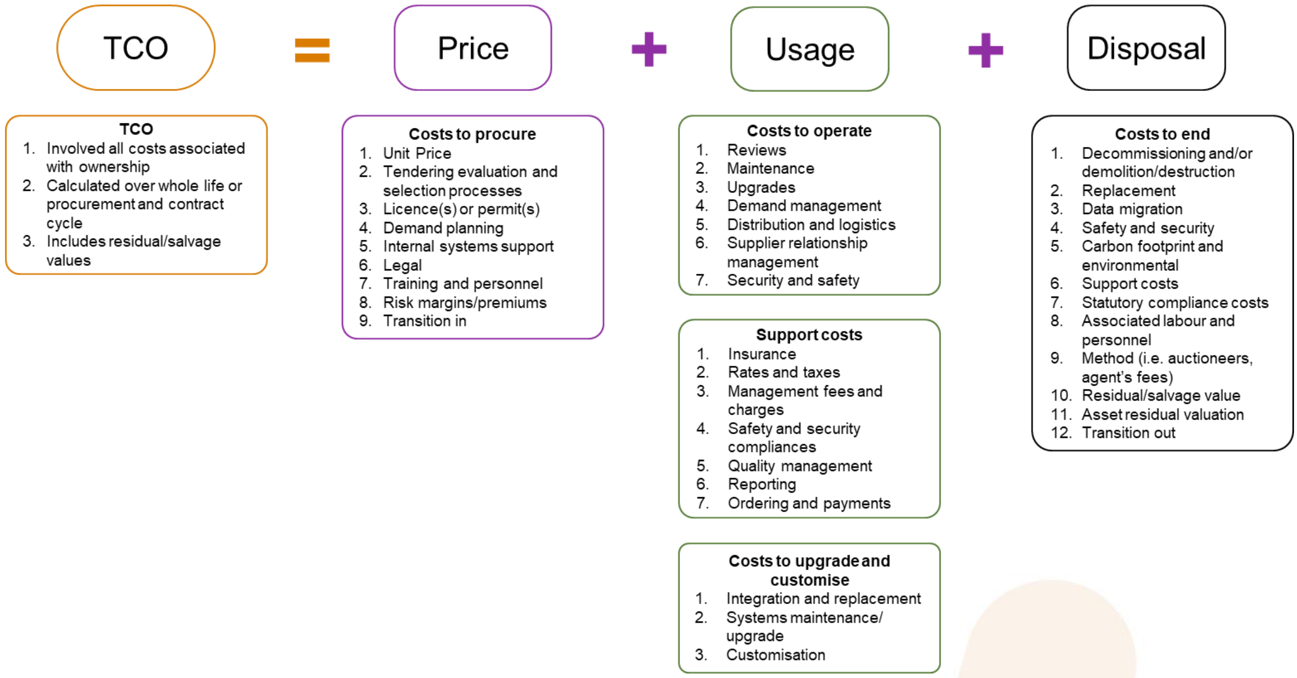
Calculating whole-of-life costs involves a number of steps, including:

- Estimating the life of the goods and services
- Listing all financial costs and benefits in the year they occur
- Listing non-financial factors (e.g.: fitness for purpose, quality, delivery, service, sustainability, human rights (e.g., modern slavery factors, etc.)
- Choosing a method of analysis (for example, net present value, sensitivity analysis)
- Determining the uncertainty of the data being used

- Calculating the whole-of-life-costs.

Figure 1 below illustrates the important elements of the TCO.

Figure 1: Important elements of TCO



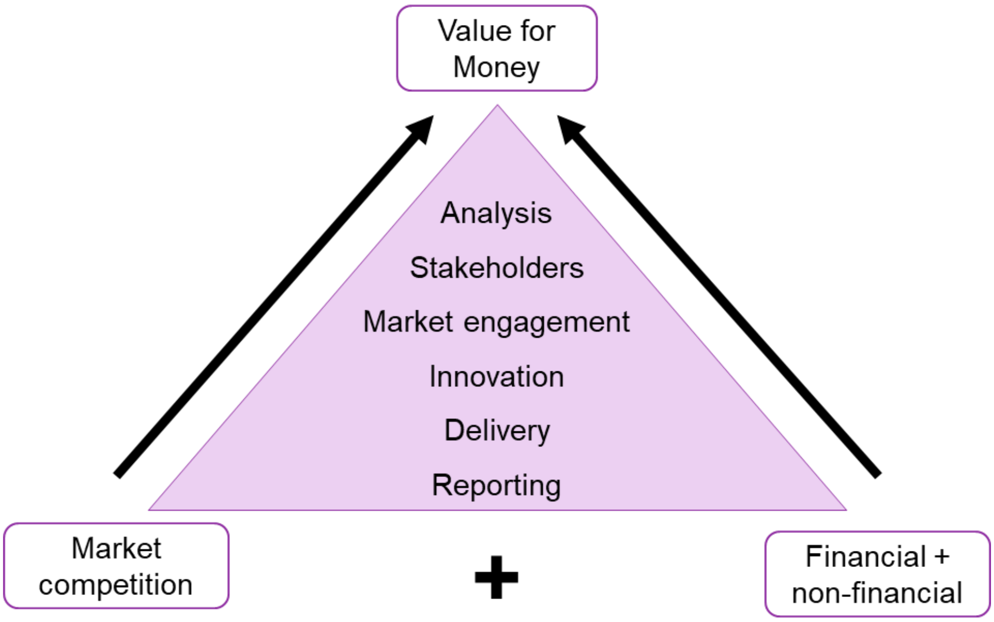
How to apply and measure VFM/TCO

TCO takes into account the entire mix of quality, costs and resources, as well as fitness for purpose, timelines and risk. Financial and non-financial factors are critical elements for measuring the TCO/VFM.

The Appendix shows TCO/VFM drivers aligned against key elements of the procurement process.

Figure 2 shows TCO/VFM drivers and the procurement process.

Figure 2: TCO/VFM drivers and the procurement process

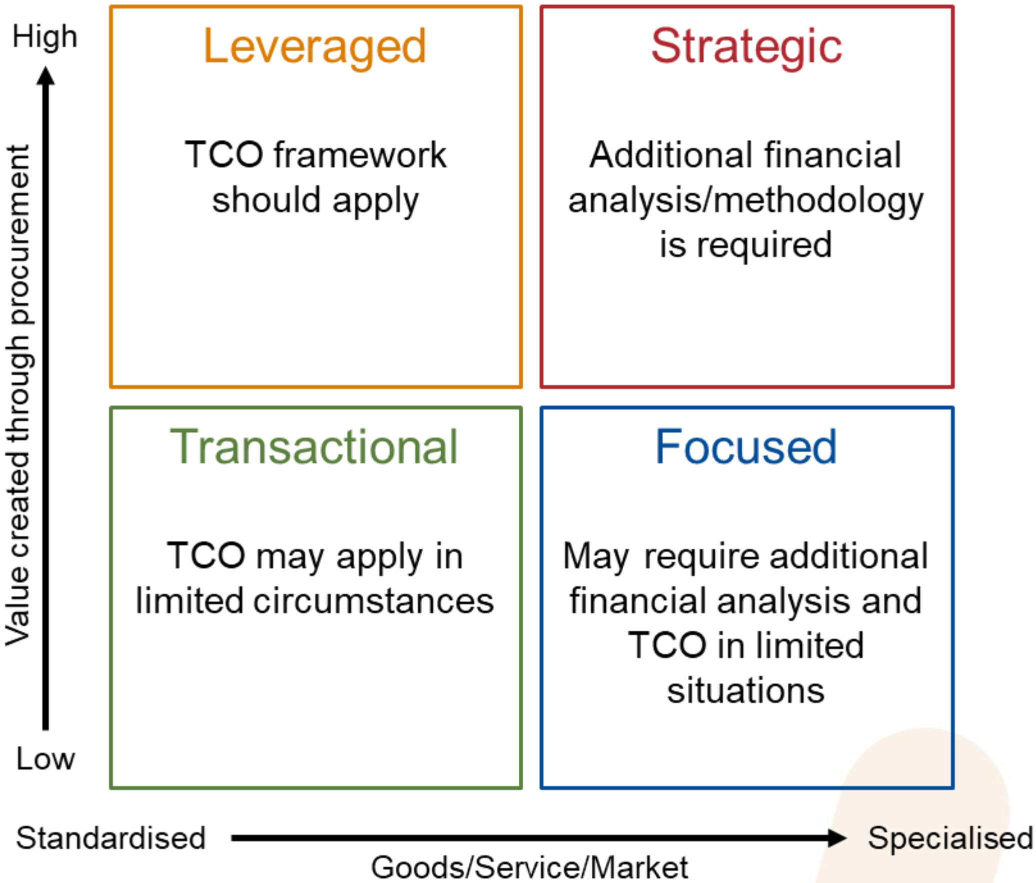


Scope of application

There are a number of ways (or metrics) to analyse cash flow to calculate TCO. For example, net present value (NPV), return on investment (ROI), and internal rate of return (IRR). These metrics are most applicable to procurement categories assessed as high risk/high focused nature; you can determine the TCO of a procurement activity using the TCO analysis framework in *Figure 3*. The following assumptions apply:

- Costs are total project costs (including price, usage, disposal and ongoing maintenance/warranty commitments)
- Use of full dollar value
- Application of a standard three to five year contract timeframe, including options to extend
- Identified cost increases arising from Consumer Price
- Index and Carbon Pricing Mechanism adjustments.

Figure 3: Applying TCO assumptions to levels of procurement complexity



Competition and market development/innovation

Competition and contestability are important drivers in achieving value for money. However, participation in a procurement exercise is a cost to suppliers and is particularly significant for SMEs. The cost of unsuccessful bids by an SME can be a major disincentive to participation. These costs should be considered when selecting a market engagement strategy. Letting the market know that VFM is an important consideration alerts suppliers to the fact that they can include product and service enhancements and innovation when submitting a bid.

Non-financial factors

Applying non-financial requirements can have a significantly positive impact by broadening the benefits that are delivered. Non-financial aspects of VFM can be more difficult to measure. However, these indicators can be used to predict the overall value of the procurement. Non-financial factors are best measured on a case-by-case basis. Variables include stakeholder satisfaction, community/client participation and outcomes outside of the intended procurement objectives.

Examples of benefits that can arise from procurement include:

- Enhancing marketing competition
- Job creation
- Economic and social benefits of procuring from small and medium enterprises (SMEs), local industry and not-for –profit organisations
- Reducing carbon footprint
- Engaging suppliers and influencing the supply chain to behave and conduct business ethically and actively address the risk of modern slavery
- Encouraging innovation and productivity in a particular industry sector.

Measuring non-financial factors

There are multiple methodologies for measuring non- financial factors including welfare economics, Pareto (i.e., specifies that 80% of the consequences come from 20% of the causes, asserting an unequal relationship between inputs and outputs) efficiencies and equity economics, etc. which have particular relevance to procurement of strategic importance or where there is significance/social impact.

However, for the majority of goods and services procurement of a transactional leveraged and low-risk, focused nature, a simple approach using KPIs is recommended.

Using KPIs

Procurement managers will determine a range of performance objectives relevant to the procurement as shown in *Table 1* below. The procurement manager can decide whether to specify the scope of the indicators or let the market define how the indicators are addressed.

Table 1: Key performance indicators

Non-financial indicators	Applicability (Y/N)	How address?
Innovation		
Quality		
Risk mitigation		
Local supply/SME/NGO/participation		
Supplier ethics		
Enhancing competition		
Environmental practices		
Intellectual transfer of knowledge		
Market development/productivity		
Economic development/productivity		

Allocating and managing risk appropriately

Risk management involves the systematic and timely identification, analysis, treatment, management and mitigation of risks. To obtain value for money, an organisation must be able to proactively identify, evaluate and manage any risks, opportunities and issues arising out of the procurement process.

Risk management should be built into an organisation's procurement process. The extent of risk management will vary from following routine procurement processes to significant undertakings involving high levels of additional planning, analysis, and documentation.

Risk can arise at any stage of the procurement process and can be broadly identified as:

- **Activity:** risks surrounding scope and scale
- **Process:** risks that relate to the use of procurement procedures
- **Contract and relationship:** risks that arise as the activity is delivered
- **Termination and transition:** risks as the contract near completion.

To manage risks, organisations should consider:

- Establishing effective dialogue between the purchaser and supplier (s) to best understand the risks for the activity
- Allocating risk in an optimal manner to the parties who are best placed to manage and mitigate the risk over the life of the activity (the supplier is not always the best party to manage or mitigate certain types of risk)
- Using appropriate risk transfer and enforcement mechanisms so that the cost of risk is borne by the parties as initially agreed
- Employing an active risk management program to protect and preserve value for money in the procurement process.

Proactively managing contract delivery

Value for money spent is maintained or enhanced through the contract delivery process by:

- Granting sufficient flexibility in the contract to capitalise on any favourable changes that may arise in the market (e.g., having mechanisms in place to adjust the price and scope of term contracts to account for changes in demand)
- Using performance monitoring to actively manage the contract for time, cost and quality
- Creating sufficient incentives within the contract to encourage innovation and efficiency in delivering the outputs
- Encouraging collaborative processes between suppliers and purchasers
- Setting the contract term to account for changes in technology and the requirement to refurbish to maintain any assets or resources put in place
- Developing contract management skills and expertise to ensure that value for money spent is maintained or enhanced.

Monitoring performance

Performance monitoring aims to provide actions that support improved decision making, and to facilitate continuous improvement in procurement practice and, ultimately, contribute to the maintenance or enhancement of value for money spent through the procurement process.

Organisations should collect information on the time, cost and quality of the delivery of outputs. In the context of procurement, these measures will indicate whether the outputs are being delivered in an efficient, cost effective way to the agreed quality standard, thereby maintaining or enhancing value for money spent.

To successfully monitor performance, organisations should also engage in ongoing dialogue with suppliers. Such dialogue contributes to a shared understanding of objectives and scope, and to the timely identification of risks that might undermine the efficient, cost-effective delivery of outputs.

Performance monitoring will help organisations to identify the reasons for any losses or gains (e.g. supplier selection, project scope, contract management, or matters beyond the control of either the organisation or the supplier(s)).

Over time, information gathered can be used to benchmark the performance of both organisations and suppliers, indicate where training and capability improvements are required, and contribute to the development of best practice procurement processes.

More information

Related documents and templates are available on the HSV website.

Disclaimer

The information presented in this document is general in nature and based on HealthShare Victoria’s interpretation of the *Health Services Act 1988 (Vic)* and any ancillary legislation and regulations in effect at the time, and should not be relied upon as legal advice. Please consider seeking professional and independent advice from your legal representative as to the applicability and suitability of this information and the legislation to your own business needs or circumstances.

Appendix 1: VFM evaluation checklist template

Procurement Process Elements		VFM Drivers	Considered (Y/N)	How was this achieved?
1	**Planning**	Have procurement decisions been made in an accountable and transparent manner?		
		Is the procurement aligned with the business strategy of the organisation?		
		Has the department considered the capacity for this procurement to achieve better results, using the same resources?		
		Is the procurement process maximizing competition in the market?		
		Have the financial and non-financial outcomes been defined?		
		Has the performance history of each prospective supplier been considered?		
2	**Financial and TCO**	Does the procurement have the flexibility to adapt to possible change over the life of goods/service?		
		What are the financial considerations of direct/indirect benefits of the procurement?		
		Is the good/service procured fit for purpose?		
		Are the whole of life costs commensurate with budgeting and long-term financial goals?		
		Are the transaction costs associated with acquisition, use/holding, maintenance and transaction/re-use/recycle costs related to disposal been considered and deemed appropriate?		
3	**Non-financial factors**	Does the procurement seek to achieve/advance government policy objectives?		
		Are the stakeholders involved satisfied?		
		Has the procurement had a positive effect on innovation in the marketplace?		
		Have the resources been used efficiently so as to maximize customer service levels, minimise lead times, and optimise inventory levels?		

Procurement Process Elements		VFM Drivers	Considered (Y/N)	How was this achieved?
		To what extent has the procurement addressed environmental sustainability/modern slavery etc?		
4	**Quality of procurement**	Is there an adequate level of quality of service?		
		Is there an adequate level of support?		
5	**Contract Management and delivery**	Is there opportunity for the evaluation of contract options?		
		Has the 'optimum' balance between cost and non-cost factors been achieved?		
		How has 'value' been described in the contract?		

The table is an example only. Add your own drivers relevant to your specific procurement activity.