OGC

Office of Government Commerce

Value for Money Measurement

OGC Business Guidance

May 2004

Value for Money Measurement

Contents

Value for Money Measurement

1. Introduction

1.1 This guidance describes the methodologies for quantifying value for money gains from procurement activity in central civil government in England. Other public sector bodies may also wish to use this guidance.

2. Background

2.1 The Gershon Review examined the whole process of acquisition from third parties, including goods services and large capital projects. It spanned the complete life cycle from initial inception through to the end of the useful life of the asset or completion of the contract.

2.2 The Review identified areas where improvements could be made in Government procurement and made recommendations covering organisation, process, people and skills, measurement and the contribution of the 'centre'.

2.4 The methodologies described in this guidance will help departments improve their ability to manage their business processes and measure progress in delivering their planned commercial efficiencies.

3. Development of the Guidance

3.1 This guidance was developed by an interdepartmental group with representation from the National Audit Office following wide consultation with academia, the private sector and professional bodies.

3.2 The methodologies recommended have been selected on the bases of being simple, robust and auditable. They provide common principles and specified processes only to the extent necessary to allow aggregation of data to support the measurement of achievement against PSA targets.

4. Applicability

4.1 Value for money gains are defined as improvements in the combination of whole life costs and quality that meet the user's requirements. They will be secured as a result of positive action by staff involved in commercial transactions.

4.2 The measurement methodologies can be applied to all procurements of goods, services and works and include those for projects, IT, construction and property; and to any programme spend where there is a proactive and definable procurement influence.

4.3 This methodology should be used by all in central civil government unless more accurate measurement is available locally.

5. Methodologies for Calculating Value for Money Gains

5.1 Four main categories of value for money gains from procurement activity have been identified. These are:

- individual departments negotiating an improved deal with a supplier
- aggregating demand across departments to exert greater leverage on suppliers.
- reducing process or transaction costs
- improving project, contract and asset management

5.2 Methodologies have been developed for identifying and calculating value for money gains in each of these 4 categories in the following section of this guidance.

5.3 Measurement of significant value for money gains should preferably be targeted on the larger expenditures as calculation of a multitude of smaller value for money gains is not generally cost effective.

5.4 Departments will need to set their own expenditure thresholds above which they routinely calculate individual value for money gains eg expenditures over £500k over the life of the contract or asset. The value for money gains may be calculated retrospectively or, more likely, as part of business case justification for the activity.

5.5 All smaller value for money gains may be assessed using the low value calculator.

5.6 *Negotiation of an improved deal with a supplier*

Vfm gains negotiated with a supplier by an individual department may be realised in the following areas:

Price saving – the amount by which the last price paid for the goods or services (if one exists) or the current best value market price (based on tenders received and whole life costing) is improved by negotiation.

Price avoidance – the amount by which a supplier's price increase request is reduced – aiming towards zero.

Better terms – warranties, guarantees, payment bases, reduced stock holding.

Improved quality – based on reducing whole life costs.

Improved volume – increasing the amount of goods or services supplied for a given price.

5.7 *Calculating the Benefits*

Price savings/volume gains – these should take account of inflation/deflation (see Technical Notes).

Better terms/improved quality – these will be realised through the saving of staff time (based on full costs or 2 x salary if these are not available) or on reducing whole life costs.

5.8 *Vfm Gains through Aggregation*

These will be realised through aggregation of demand through centrally awarded call off contracts set up by specialist procurement agencies or departments acting as lead buyers.

Benefits will vary from department to department but may include

- reduced prices
- better terms eg warranties and guarantees
- savings in transaction costs
- shortened implementation timescales

Benefits calculations must take account of the full cost of purchasing and cover:

- contract cost/price over whole life
- full staff costs allowing for overheads
- lead buyer costs which need to be deducted from the savings achieved.

5.9 *Calculating the Benefits*

Vfm benefits should be calculated by comparing 'before and after' in a number of areas as follows:

Supplier charges/reduced prices

- these should be assessed over the whole life of the contract/life of the asset acquired.
- charges/prices should be adjusted to take account of inflationary/ deflationary price movements by using an index appropriate to the procurement or, if one is not available, use RPI
- benefits realised by each department should be calculated pro-rata for their spend compared to the total contract.

Staff time:

- savings in staff time should be calculated on the bases of full costs or 2 x salary (see Process costs above).

Added value – better terms and conditions

- the evaluation of these will depend on the circumstances in the particular department but should show in lower maintenance ie whole life costs and reduced staff time.

Shorter timescales and saving in administration costs

- these will be realised through savings in staff time (see above).

5.10 ***Process or Transactional Vfm Gains***

The key activities where process vfm gains may be achieved are:

- sourcing
- tendering
- order and acknowledgement
- receipt documentation and internal delivery or installation
- invoice receipt matching and bill payment

The benefits will be realised through:

- a reduction in operating costs through the ability to reduce staff time (internal or external) on that particular work
- reduced stock holding (where relevant) due to reliability and speed improvements
- avoiding the need to undertake a procurement

Initiatives that may generate benefits are for example:

- use of procurement cards
- electronic catalogues/e-commerce/tailored shipping lists
- consolidation of delivery
- consolidation of invoices
- improved information systems
- reduction in the number of consultants and advisers
- reduction in queries/mistakes/mismatches
- reliability and speed improvements – may generate both a time and stock saving
- consolidation of payments
- electronic tendering
- standardisation of contract documentation
- standard project methodology and approach.
- challenging initial requirements in terms of volume, quality etc.

5.11 ***Calculating the benefits***

Staff time:

- staff value should be calculated on the basis of full costs or 2 x salary.

Stock reductions:

- stock reductions should be taken as a one off benefit and calculated on the basis of the current replacement value of stock reduced.

Procurement avoidance:

- estimated purchase cost or budget, plus savings in transaction costs.

5.12 ***Project, Contract and Asset Management***

For the purpose of measuring value for money gains total project cost can be split into 3 components

- the investment cost – consisting of the capital cost of the asset or service

- the process management cost – this includes all the in-house and external costs of the procurement process

- the lifetime operating or servicing costs – the costs of running, maintaining and disposing of the asset where appropriate.

A cross-departmental group, including the NAO, agreed a methodology for calculating gains arising from Gateway reviews. The gains are calculated centrally by OGC. You <u>do not</u> need to estimate gains from Gateway reviews separately.

For projects and contracts which do not go through the formal Gateway Review process the methodology for calculating vfm benefits from process cost reduction and negotiation of an improved deal with suppliers, should be used.

Annex 1

Technical Notes

The following notes provide guidance on the treatment of specific issues associated with assessing value for money gains.

Who should claim Value for Money Gains

The guiding principle should be that the department, agency or NDPB that finances the particular procurement should claim any value for money gains achieved. This is on the basis that it is only this body that is in a position to deploy any savings or benefits achieved.

Inflation

The effects of price inflation/deflation should be taken into account when calculating value for money gains in order to compare prices on a like for like basis.

Where there is an appropriate index for the particular procurement this should be used, otherwise the Retail Price Index (RPI) should be used.

Value Added Tax (VAT)

VAT should be excluded from all value for money calculations when reporting gains to OGC for the purposes of cross-departmental aggregation. For internal departmental purposes, calculations may be presented on a gross or net basis to reflect local circumstances.

Avoidance of Double Counting

Where department and agencies collaborate to effect a procurement there is a risk that the perceived benefits will be double counted. To avoid this the following protocols are recommended.

Aggregation benefits

The Central Office of Information (COI) and OGCbuying.solutions will calculate the VFM gains related to their activities, OGC will also calculate the gains from the principal aggregation deals centrally.

- for other aggregation deals, benefits should be claimed by participating departments.

Retrospective Rebates

- these should be recorded by the Lead Buyer but allocated to departments based on their spend.

Future Year Gains

Where future year value for money gains fall within the Spending Review (SR 2000) time horizon they should be claimed in the year in which the savings are achieved.

If value for money gains fall beyond the SR time horizon net present value (NPV) should be calculated using standard HM Treasury methodology, and reported separately as part of the total gains for the year. Future year estimates will need to be periodically reviewed to verify they are still valid and being realised.

Low Value Items

A simplified methodology has been developed to allow streamlined calculation of vfm gains associated with low value expenditures. This is based on interdepartmentally agreed factors which determine the effectiveness of a procurement operation. The resulting index is then applied to the aggregate of your low value expenditure. A ‘cap’ of just under 3% vfm gains is applied. This calculator is available from OGC in electronic spreadsheet form.