Broadleaf

Creating value from uncertainty

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Technical note: Tender price risk

Tender risk assessment enables the comparison of alternative bids with different prima facie technical and commercial offerings and headline prices. This allows a rational comparison of low-cost offers with limited capability against higher-cost bids with high grade expertise, where both may be acceptable at face value but implementation is expected to play out differently depending on which one is selected.

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1 Introduction

Requests for tender specify what a customer wants. They usually also define how tenders are to be laid out so that competing bids can be compared on a like-for-like basis. However, there are factors that can get in the way of a clean like-for-like comparison.

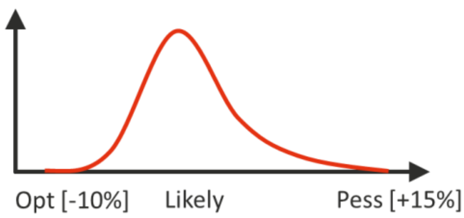
- Despite having a defined requirement and tender format, unless the goods or services being procured are very simple, suppliers often offer something slightly different from the requirements specification and vary the presentation of their bids.
- Suppliers have different strengths and weaknesses that can be expected to affect how they will actually deliver what they have offered.
- The customer's requirement might not be absolutely fully specified and one supplier may be better able to accommodate post-contract refinements.

To understand the implications of accepting one bid as opposed to another, it is useful to assess the actual costs that would be incurred if each tender were accepted. There is bound to be uncertainty in this assessment and it is best approached as a cost risk modelling exercise.

2 Method

As with any cost risk assessment, the cleanest and most realistic models are based on the major drivers of cost uncertainty. Reasons that the cost might differ from the value declared in the tender must be identified and analysed to understand their effect on the total cost. Very often, the variations are described as ranges in the value of costs or cost drivers. Examples of cost drivers are the amount of effort required for a part of the work or the quantity of materials or equipment that will be required. These variations may be expressed directly or in percentage terms, as illustrated in Figure 1.

Figure 1: Distribution of actual value of a quantity

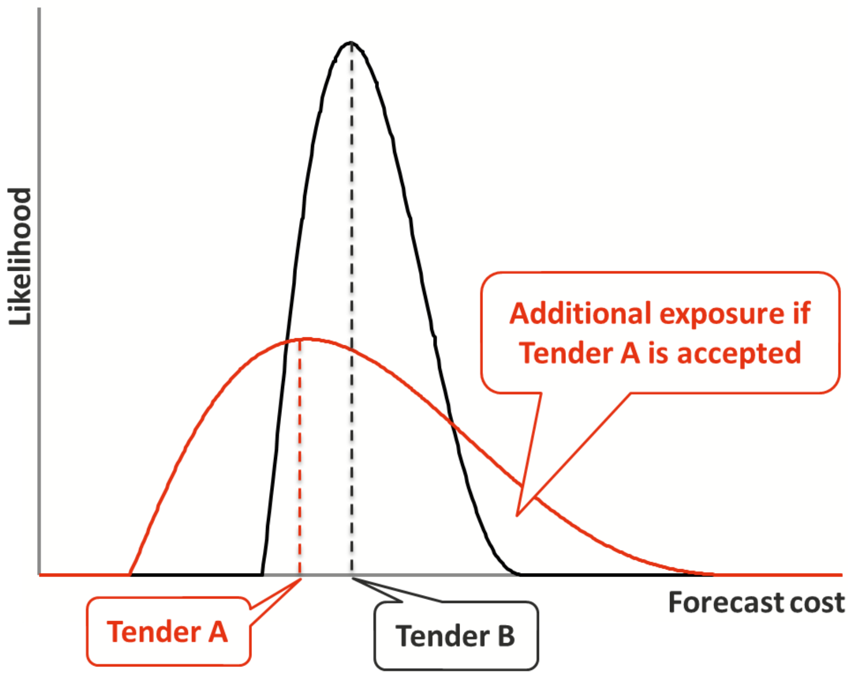


These individual distributions are combined to assess their aggregate effect on the cost using a model, as illustrated in Figure 2. The models are usually evaluated by Monte Carlo simulation.

Figure 2: Modelling the aggregate effect

The outcome of such an assessment might generate a comparative view of the costs of two tenders like that shown in Figure 3. In this illustration, Tender A offers a lower price than Tender B at first sight but, when realistically possible variations are taken into account, the low-cost bid can be seen to be less predictable than the one that appears to be more expensive. Tender A could result in a higher cost than Tender B; seeking to capture the small saving that Tender A appears to offer would actually be a risky choice that would leave the customer exposed to significant cost over-run.

Figure 3: Comparing two tenders' costs



3 Benefits

As well as providing a sound basis for comparing the costs of tenders, a tender cost risk assessment provides several other benefits.

It is an efficient and structured process with which to explore the risks associated with tenders. This can improve the quality of the tender evaluation as a whole as evaluation team members develop and share their understanding of the risks.

The understanding developed when preparing the model and estimating cost variations contributes to commercial negotiations with the preferred tenderer. Special forms of the analysis and modelling are used for setting contractual limits of liability with the preferred bidder (as described in detail elsewhere).

When a decision has been made, the analysis and its conclusions are very useful in debriefing the unsuccessful bidders. So long as the analysis is conducted well, it provides a documented rationale for the decision that can help to defuse objections or challenges.

The understanding developed by carrying out the cost risk assessment is a valuable foundation for the purchaser's risk management for the procurement. As part of this, exploring the uncertainties with the supplier will often enhance cost control and improve the quality of the delivery.

The distribution of forecast costs for the chosen tender can be used to set a budget and contingency for the purchase. This supports governance and financial decision-making by reducing the danger of unanticipated demands for funding.

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