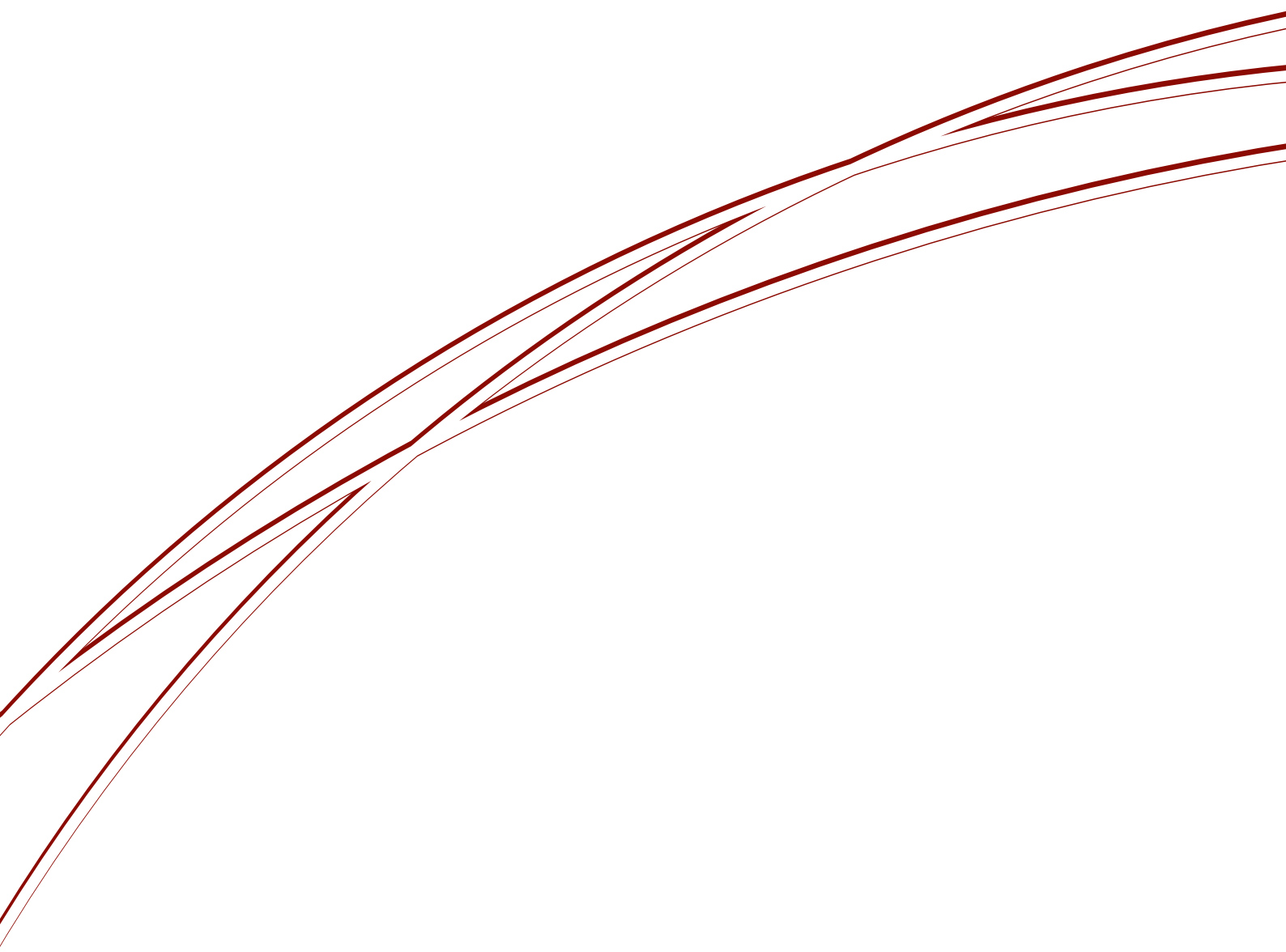
ICAC

INDEPENDENT COMMISSION AGAINST CORRUPTION

NEW SOUTH WALES

DIRECT NEGOTIATIONS: GUIDELINES FOR MANAGING RISKS

AUGUST 2018



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Public sector organisations are welcome to refer to this publication in their own publications. References to and all quotations from this publication must be fully referenced.

ICAC

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Chapter 1: About direct negotiations

What are direct negotiations?

The term "direct negotiations" refers to exclusive dealings between an agency and a counterparty[1] without first undergoing a competitive process. Direct negotiations are sometimes referred to as directly sourced, single-sourced or non-competed contracts.

Direct negotiations and corruption risks

The closed nature of direct negotiations can create opportunities for dishonest and partial conduct and is more likely to lead to allegations and perceptions of corrupt conduct. Having to compete for a government contract, in a fair and transparent manner, is a significant obstacle for corrupt individuals.

Direct negotiations are highly sought after and many of the investigations undertaken by the NSW Independent Commission Against Corruption ("the Commission") involve attempts to avoid competition (see the case study below). The corruption risks associated with direct negotiations are significantly higher than those associated with open processes such as tendering and other forms of market testing. Direct negotiations can also be detrimental to the public interest; for example, by undermining the potential for government to realise the full value of public assets.

However, direct negotiations are not, by themselves, corrupt.

Where it is considered appropriate to engage in direct negotiations, it is critical that greater attention be paid to measures to mitigate the risk of corruption and ensure adequate levels of integrity.

Direct negotiations can involve corrupt conduct

Winning a directly-negotiated contract with a government agency can be lucrative. Private sector organisations have a strong incentive to engage in a variety of tactics and techniques, which may or may not be ethical, in order to secure these benefits.

The Commission investigated a matter where a company, which provided infrastructure services to a public sector agency, sought exclusive rights to build water infrastructure in north-western Sydney. The company made repeated, strong representations in favour of direct negotiations, even though expert assessments showed that this represented poor value for money. Despite this, there was nothing corrupt about the company advancing its interests in this way.

However, the Commission eventually determined that a number of public officials, including one that had a hidden personal interest in the company, engaged in corrupt conduct by, among other things, preparing a misleading draft Cabinet minute that favoured the direct negotiations.

Source: *Investigation into dealings between Australian Water Holdings Pty Ltd and Sydney Water Corporation and related matters,* August 2017.

[1] In this publication, the term "agency" is used to describe any public sector organisation. The term "counterparty" is used to describe the non-agency party to the transaction (typically, an individual or private or not-for-profit sector organisation).

The Commission's position

As a general rule, direct negotiations should be avoided unless they clearly fall within the government's legislative and policy framework and/or the risk of corrupt conduct has been managed in accordance with these guidelines. Agency policies, procedures and customs should discourage the use of direct negotiations and impose strict obligations on officers who seek exemptions.

There are, nevertheless, some circumstances in which direct negotiations may be considered.

Where might direct negotiations arise?

Direct negotiations typically accompany a discretionary transaction or dealing that confers something of potential benefit on a counterparty. Transactions or dealings that cannot be conceived of in terms of an open or competitive process, do not give rise to direct negotiations. For instance, a citizen applying for a driver's licence is obviously a direct dealing but it does not make any sense to think of this transaction as something that could be conducted as a competitive process.[2]

The potential for direct negotiations can arise from a range of contexts; from small, verbal agreements to large multi-million dollar agreements. The areas where they can occur are set out below.

Procurement

Direct negotiations most commonly arise as part of some form of government procurement. This can range from small credit card purchases and purchase orders through to the largest and most complex infrastructure projects in the state. Most of the examples and concepts in this publication are related to procurement.

Investment activity

Private financing of public infrastructure and amenities has emerged as an alternative to more traditional forms of procurement. This has led to private sector financiers taking debt and/or equity positions in public projects. Similarly, in some circumstances, public sector agencies may invest or lend funds in the private sector.

Delivery of government services

Under mechanisms such as public-private partnerships and more recent commissioning and contestability reforms,[3] a wide variety of government services can potentially be delivered by non-government providers. In many ways, this is a form of procurement but it does represent a fundamentally different approach to delivering services.

Joint ventures

Where an agency cannot deliver a project or service with its own resources, it may choose to enter into a joint venture arrangement with another entity. In this situation, the joint venture partner is not working for the agency under a traditional procurement contract as much as it is working with the agency to co-produce an

[2] Public sector agencies are party to a range of transactions that do not technically meet the Commission's definition of a direct negotiation but, nonetheless, carry some of the same risks (for example, assessing a complicated development application, a contract variation or voluntary planning agreement). The advice in this publication may also be of general assistance in these situations..

[3] *NSW Government Commissioning and Contestability Policy*, TPP 16-05, NSW Treasury, November 2016.

outcome. In some cases, a separate entity with a board and shareholders is established to manage the joint venture.

Disposal

This can refer to more than just disposal of surplus goods or property. Agencies can also dispose of intangible assets such as intellectual property, leases, airspace, management rights and advertising space.

Employment

Most agencies have recruitment and labour hire policies that require vacancies to be advertised or made available to a range of candidates. However, on occasion, the need for direct appointment can arise; for example, to cover emergencies on a short-term basis.

Licences and rights to use natural resources

Government agencies often licence, sell or award the right to use natural resources such as water, fisheries and mineral deposits. On occasion, these entitlements are also bought back by government. All of these transactions can potentially involve direct negotiations.

Sponsorships

Agencies sometimes approach, or are approached by, companies or groups seeking to enter into a sponsorship arrangement.

Grants

Many agencies regularly make cash or in-kind grants to the private and not-for-profit sectors, such as grants for community projects.

Business proposals

It is not uncommon for a counterparty to approach an agency with an innovative idea or business proposal that may have a commercial or entrepreneurial component. This could come from an incumbent contractor (for example, with an idea to uplift the value of an existing deal), a counterparty that has no association with the agency, or even a member of staff. On occasion, business opportunities may also be agency-led. These proposals may not require public funds (and therefore would not be classed as procurement or a grant) but may entail a form of government endorsement, concession or input.[4]

Example of direct negotiations arising from a business proposal

A software developer might approach a government agency with an idea for a new smartphone app that purports to assist the agency's customers in some way. The software developer might not ask for any of the agency's funds but could seek its advice and endorsement.

Data

Many agencies hold significant volumes of data that could be of value to a counterparty. Quite apart from the privacy consideration involved in providing data, agencies may find themselves in a situation where access to data is sought by direct negotiation.

Bartering arrangements

Agencies sometimes enter into agreements to exchange assets, goods and services in kind, rather than transacting in cash.

[4] Additional guidance can be found in the NSW Government's *Unsolicited Proposals – Guide for submission and assessment*, August 2017.

Chapter 2: Deciding whether to undertake direct negotiations

As noted in chapter 1, direct negotiations should generally be avoided. However, there are situations where it may be impossible to test the market or to use a competitive process. In other cases, while a competitive process may be possible, it may be so impractical or expensive that direct negotiations are the most acceptable way to transact.

The Commission has identified a number of circumstances where direct negotiations may be appropriate. Agencies should, however, use these only as a guide to decision-making and always bear in mind that, just because these circumstances apply, direct negotiations may still not be the best way to proceed. Agencies can often avoid direct negotiations, simply by opening up the process to some degree of competition.

The *Market Approaches Guide*[5] published by the NSW Procurement Board ("the Procurement Board") assists agencies to identify the approach that best fits their procurement needs. Procurement Board Direction 2013-02, *Statement on the Promotion of Competition*, directs agencies to promote competition.

Criteria for undertaking direct negotiations

Agencies should ensure they fully examine claims that direct negotiations are the most suitable course of action and that they explore any alternative courses of action. In addition to the following, agencies should also rely on the probity principles (see chapter 3) to guide their decisions.

The changing nature of competitive processes

Some people equate "competition" with completely open processes, where offers are sought by placing advertisements in newspapers and on the internet and any party can submit a proposal (for example, an open tender or public job advertisement). Experienced procurement officers are, of course, familiar with the numerous alternatives to open tendering, which still maintain a level of competition.

For clarity, when the Commission states that direct negotiations should be avoided in general, this does not mean that all transactions need to be subject to completely open, advertised processes.

It should be noted that a number of non-traditional contracting models have emerged that lie between open tendering and direct negotiations (see chapter 1).

Exemption by statute or government policy

There are areas where direct negotiations are either permitted or required by statute or government policy. This publication is not intended to provide a complete list of these statutory or policy exemptions but some examples are listed below.[6] See also page 11 , which deals with low-value transactions.

- The NSW Department of Premier and Cabinet's *Unsolicited Proposals: Guide for Submission and Assessment*[7] sets out a framework for considering certain transactions initiated by a counterparty.

[5] Last updated April 2015.

[6] Accurate at the time of publication. Agencies should check for updates.

[7] Published August 2017.

The NSW Treasury's P*ublic Private Partnership Guidelines 2017* also contain guidance on direct negotiations.

- From time-to-time, the Procurement Board issues directions that permit direct negotiations.[8] These include procurement thresholds under which just one valid quotation is required. The Procurement Board also maintains a number of panels that agencies can use (in some circumstances, without seeking multiple quotes). Individual agencies may also be accredited by the Procurement Board to conduct certain directly-negotiated transactions.
- Section 55(3) of the *Local Government Act 1993* sets out some exemptions to the general requirement to invite tenders for contracts. Individual local councils have their own policies setting out when multiple quotations are required for certain transactions.
- Section 348 of the *Local Government Act 1993* states that job vacancies must be advertised but there are exceptions for reappointments and short-term appointments.
- The *Government Sector Employment (General) Rules* 2014 include some situations where direct negotiations are permissible in employment-related matters.
- NSW Treasury occasionally issues guidance regarding the disposal of assets, some of which can be sold directly to an interested party.

Uniqueness

Where a counterparty is in a unique position to offer a solution that cannot be offered by competitors, it may be reasonable to consider direct negotiations. In order to be suitable for direct negotiations both the counterparty and its proposal should be unique.

The agency might assess if the entire proposal or significant aspects of it are unique. In relation to its unsolicited proposals framework, the NSW Department of Premier and Cabinet has advised:

> *This may include genuinely innovative ideas, including financial arrangements or solutions that are otherwise unlikely to be defined and put to market (e.g. alternatives to providing a Government service or substantive processes, products or methods for delivering a service that is offered by other service providers and constitute a significant departure from traditional service delivery).*[9]

Before agreeing to direct negotiations, the agency should ensure that the "unique" solution offered by a counterparty is the only viable solution to its requirements. Even if a counterparty claims an apparent unique ability to deliver a particular project, the agency can keep competition open and transparent by seeking expressions of interest in outcome-based terms. This approach may require more dialogue with proponents to avoid vague or ambiguous tenders.

Agencies should also be wary of approaching the market with highly prescriptive requirements, which may unnecessarily narrow the field of potential counterparties. Again, in order to prevent this, in some cases, it may be appropriate to use outcome-based criteria.

Another approach is for an agency to pilot innovative solutions through a short-term proof-of-concept contract with a supplier, in accordance with Procurement Board Direction 2016-05, *Procurement Innovation Scheme*. Under such arrangements, the counterparty agrees that the agency is permitted to publish the outcome of the trial. In situations where proof-of-concept testing or a trial is directly negotiated with a supplier, any subsequent procurement of goods or services must be through a competitive procurement process, allowing other potential suppliers scope to compete.[10]

Monopolies

When it is beyond doubt that there is only one counterparty that can meet an agency's well-defined needs, direct negotiations can be justified. Where there is any doubt, or the agency has assumed rather than demonstrated that there is no competition, it should test the market.

Agencies need to verify the existence of a monopoly market with an adequate fact-finding process and justify how value for money can still be achieved through a direct negotiation. For obvious reasons, an agency should never rely on claims by a counterparty that it is the only provider in the market.

[8] Examples include the *Aboriginal Procurement Policy* (May 2018), which contains provisions for direct negotiations, and Procurement Board Direction 2016-05, *Procurement Innovation Scheme*, which permits direct negotiations for certain feasibility or proof-of-concept trials.

[9] *Unsolicited Proposals – Guide for Submissions and Assessments,* NSW Department of Premier and Cabinet, August 2017, p. 5.

[10] Procurement Board Direction 2016-05, *Procurement Innovation Scheme,* requires accredited agencies, amongst other things, to undertake a comprehensive market analysis demonstrating that a competitive process need not be conducted, to assess the risk arising from the use of direct negotiation and to have high-level approval of the procurement activity.

A questionable assertion

A NSW government agency hired a project manager to oversee a software development project. The project manager was tasked with appointing a number of temporary programmers to complete the project. He claimed that there was only one company – Company X – that had the staff with the necessary skills and availability to undertake the project. This argument was accepted and programmers from Company X were directly appointed.

The project manager's assertion was false. A subsequent investigation showed that a number of organisations, besides Company X, were able to undertake the project and employment agencies could have provided qualified programmers on a contract basis.

The investigation also found that the project manager had a hidden financial interest in Company X, which obviously motivated his desire to avoid a competitive process.

Intellectual property rights

Where intellectual property forms a necessary part of a project and ownership of that property can be demonstrated, agencies may have to agree to direct negotiations. Before making the decision to enter into direct negotiations, it is essential that the agency verifies that the counterparty is the only holder of the intellectual property, that similar intellectual property held by others would not be a reasonable solution, and that the intellectual property really is core to the agency's needs for the project. Claims that a counterparty makes about its intellectual property rights should be verified.

A counterparty that claims ownership of significant intellectual property might – as a precondition to providing details of its proposal – ask the agency to sign a confidentiality agreement. Agencies should take great care to ensure that the wording of such an agreement does not inadvertently confer exclusive rights on the counterparty.

Expert legal advice should generally be sought before an agency enters into any agreement that relates to the ownership and use of another party's intellectual property.

Real property rights

If a particular counterparty owns a parcel of real property that is on, or near, the site of a proposed project, direct negotiations may be justified on the basis that the land is necessary to the project. Real property includes not only land, but also airspace, long-term leases, mining rights, easements, options and other rights over land. In some cases, it may be practical for an agency to purchase or compulsorily acquire the property, but these processes can be time-consuming and expensive. Using the same rationale, there may also be situations in which an agency sells or leases real property via direct negotiations.

Interface with an existing facility or product

On occasion, a public project or acquisition needs to interface with an existing piece of equipment, technology or facility. Acquisitions of replacement parts, minor extensions, continuing services for existing equipment and minor software upgrades may not be amenable to a competitive process. Direct negotiations may therefore be unavoidable where the purchased items must be compatible with an existing product. As noted elsewhere in this publication, agencies should be mindful of the whole-of-life costs of their activities, including maintenance and repair costs.

The need for a project to interface with an existing facility should not, however, give a counterparty an automatic right to direct negotiation. The agency should assess whether alternative contractors could potentially undertake the work at a competitive price. Agencies should be cautious about misusing the interface criterion either as a basis for agreeing to direct negotiations at the behest of an incumbent or to avoid the short-term time and expense associated with the competitive process.

Transactions that derive from an earlier competitive process

Rather than enter into a principal-agent relationship with a counterparty, agencies sometimes create joint-venture relationships or similar partnering arrangements. Selecting a joint-venture partner should be a competitive process. However, the venture itself, once established, may entail direct negotiations between partners for the sourcing of goods and services and other transactions that fall within the scope of the joint venture. This can be justified provided the parties anticipate it during the original selection process.

Similarly, agencies may enter into an outcome-based contract in which it is expected that parties will need to complete a number of individual transactions in order to achieve the contracted outcome. It may be appropriate to use direct negotiations to complete some of the smaller transactions that derive from the broader outcome-based contract.

Agencies should be wary, however, of contract variations that confer unnecessary benefits on a counterparty. While these may be the product of legitimate needs, they occasionally involve corrupt conduct. Contract variations

can also be a mechanism by which the counterparty increases revenue received or reallocates risks back to the public sector. Sometimes claims for contract variations are more appropriately dealt with by agencies as new contracts that are offered to the market. Certain issues, such as whether a proposed contract variation constitutes a significant change in project scope, and the value of the variation compared to the original contract value, are relevant in deciding whether to establish a new contract.

To avoid damaging the public interest

Sometimes, for reasons beyond its control, an agency changes its policy or commercial direction while a transaction is under way. This could arise in a variety of circumstances, including a sudden gain or loss of funding, a legal judgment or new legislation, a serious mistake or even a change in government.

These changes have the potential to cause losses to affected parties, which in turn may create liabilities for taxpayers or damage the public interest in other ways. In some cases, going back to the market or restarting the process might aggravate these liabilities, without any net gain to the public. Where it can be demonstrated that this is the case and value for money has been considered, direct negotiations may be warranted. This criteria, however, should not be used to justify poor planning or to excuse ad-hoc decision making.

Emergency circumstances

In situations where a delay would threaten public health and safety, damage the environment or create a serious legal or financial risk to the agency or the government, direct negotiations may be warranted. For example, if a critical supplier unexpectedly fails to deliver goods and services, direct negotiations with an alternative supplier may be necessary. Poor planning or looming deadlines do not constitute emergency circumstances.

Clause 4 of the Public Works and Procurement Regulation 2014 sets out circumstances in which emergency procurement can occur and s 55(3)(k) of the *Local Government Act 1993* states that local councils are not required to invite tenders for contracts in emergency circumstances. Other legislation may include similar exemptions.

A false emergency

The Commission investigated an alleged abuse of emergency procurement in a public sector agency. The agency's normal procurement activities were conducted via an electronic system that aligned with prescribed delegations and process flows. However, during emergencies, purchases could be made outside the normal system using a manual approach.

The Commission found that an officer placed millions of dollars of emergency orders with a supplier without a tender process or a contract. This was achieved by placing multiple orders over an extended period of time.

Ultimately, some of the invoiced goods were never supplied, and the Commission made corrupt conduct findings against both the supplier and the purchasing officer based on evidence of collusion and corrupt payments.

Competitive process too expensive

It is usually appropriate to engage in a direct-negotiation process when the value of the contract or transaction is very low relative to the cost of conducting a competitive process. Most agencies have procurement policies and/or accreditation arrangements that allow low-cost purchases to be made on the basis of one quotation or by corporate credit card. However, agencies should be alert to the risk of splitting transactions so that they fall under the relevant threshold. Where practical, small regular purchases should be made from a catalogue, pre-qualified panel or period contractor. Minor variations to an existing contract may also fall into this category.

Similarly, disposal of low-value surplus items or short-term employment opportunities may justify direct negotiations.

Order-splitting

This is the practice of dividing a transaction into multiple, smaller parts to avoid competition and scrutiny; most commonly done to avoid a tender or requirement for three quotations. Sometimes, order-splitting derives from poor planning, convenience or laziness.

The Commission has found evidence of order-splitting in many investigations, and that the practice is sometimes associated with corrupt conduct. For this reason, it is important that internal controls, management supervision and post-transaction review be used to identify order-splitting.

Competitive process not successful

A direct negotiation may be appropriate when a legitimate and recently completed competitive process has failed to produce an advantageous or satisfactory offer and the agency does not expect a repeat of the process to produce a better result. In such circumstances, the agency may choose to negotiate directly with the "least unsatisfactory" of the available proponents, or another counterparty that has expressed a genuine interest.

Ideally, the initial competitive process should articulate the right of the agency to enter into direct negotiations in the absence of an advantageous or satisfactory offer.

Tips for dealing with a foregone conclusion

From time-to-time, when agencies go to market, it becomes apparent that there is just one party that has the potential to win the tender and the process has become a foregone conclusion. This situation is obviously not a direct negotiation but it does carry some probity risks.

The Commission advises agencies to consider the points below.

- The tendering process should be designed so that clearly inferior bids can be identified and culled as soon as possible. It is not fair to keep a tenderer in contention if it has no chance of success, especially if it continues to incur costs as a result.
- If only one tenderer can potentially succeed and the agency expected a better response from the market, it might question its market approach, scope of work and the risk of being locked-in to doing business with a single counterparty. That said, the agency should not refuse to transact with a counterparty just because it happens to be the only viable tenderer. In addition, agencies should not invite offers without a firm intention and capacity to proceed at the time.
- Even if just one tenderer remains in contention, the agency should still adhere to its proposed evaluation methodology. This is consistent with the public sector expectations of accountability and transparency.

Maintaining a temporary source of supply

Direct negotiations may be undertaken when it is necessary to maintain a temporary source of supply while a planned competitive process is yet to be finalised. The temporary appointment of a counterparty via direct negotiations is preferable to rushing the bidding process or automatically renewing the incumbent's contract for a lengthy period of time.

Sponsorships

Unsolicited sponsorship offers may not be amenable to market testing. For this reason, the Commission recommends that all agencies disseminate sponsorship opportunities widely; for example, by outlining these opportunities on their websites. Only when an agency has publicised these general sponsorship opportunities and has established its criteria for accepting sponsorship, may direct negotiations with potential sponsors be appropriate.

Similarly, if an agency wishes to become a sponsor, or is approached by a party seeking sponsorship, it should satisfy itself that it is obtaining value for money and that other, more advantageous, alternatives to sponsorship do not exist.

Other legal rights

In some cases, a counterparty might have some form of legal right to direct negotiations –these are typically set out in an existing contract (for example, the right to be sole supplier of a particular service). Where this is the case, the contract should be honoured and direct negotiations should take place.

Do high-performing incumbents have a right to direct re-appointment?

The Commission is sometimes asked whether it is permissible to automatically reappoint a reliable, high-performing incumbent without going back to market.

In cases where the contract already contains options permitting extension, agencies should be entitled (but not obliged) to exercise them based on a proper assessment of need and performance. However, it is preferable and fair that these options be contemplated during the original process that awarded the contract.

If the contract does not contain any conditions allowing extension, agencies should avoid direct negotiations unless other criteria in this chapter are met.

Avoiding the need for direct negotiations

Agencies sometimes find themselves in a situation where they really have no alternative but to enter into direct negotiations. With improved planning, this can potentially be avoided. Consider the following points.

Establishing and using panels

Panels of pre-qualified or approved suppliers, which have been established through competitive processes, can be

used in situations that may constitute an emergency but are in no way unprecedented. For example, a local council may have a pre-established panel to provide services during severe flooding events. A properly constituted and run panel can, therefore, be used to directly award work to panel members.

While this publication focuses on direct negotiations, rather than how to create and manage a panel, the Commission's experience is that panel arrangements are, themselves, prone to misuse. The Commission often receives complaints that a particular panel member is being corruptly favoured or that the panel is otherwise operating unfairly. It is therefore important to ensure that the panel operates effectively. For example, there should be regular reporting on the performance of panel members and which panel members are receiving work.

Avoiding lock-in

In some situations, agencies may find that once they have selected a counterparty, it can subsequently be very costly to switch to an alternative. This may occur if there are significant establishment or customisation costs, if the agency relies heavily on the counterparty's physical or intellectual property or if ancillary work such as maintenance also has to be awarded to the counterparty. This can lock an agency in to future direct negotiations with an incumbent. For this reason, agencies should always factor the whole-of-life costs of a particular course of action, including transaction and exit costs, into their planning. One of the key things to be addressed in a contract should be how to end or renew it.

There is also danger in relying on a contractor to generate and retain data that is required by the agency to operate. If the agency does not control its own data, it is at higher risk of being locked into direct negotiations.

Some agencies avoid lock-in by adopting a two-supplier arrangement, even if one of them is a little more expensive.

Bundling and unbundling contracts

Contracts can be bundled together to create larger contracts or unbundled to reduce the size of the contracts. Depending on the nature of the market, either of these options could be used to encourage additional competition and avoid the need for direct negotiations.

Agencies can also consider unbundling a contract in order to reduce its exposure to a single counterparty. For example, if an information and communications technology (ICT) supplier sells six products that an agency wants to buy, it might be the sole or monopoly provider of four of those products. The agency may have to consider direct negotiations for those four products, but it can go to market for the other two (at this time or a later stage) either alone or as part of a broader ICT procurement strategy implementation.

Finally, agencies should be mindful of the risk that a contract is split for the purpose of lowering its value to the point where competitive processes are not required.

Considering the contractor's risk and reward

The Commission spoke with some agencies about contracts that require the counterparty to make sizeable financial investments. For example, a private sector operator of a government-owned facility might need to invest millions of dollars, both upfront and over the life of the contract. In these situations, the operator may require a very long contract or argue for contract extensions (perhaps over a number of decades) in order to obtain the necessary finance and make a reasonable profit. Contractors in this situation might also have an incentive to under-invest towards the end of the contract if they do not have certainty about the future.

The Commission's position is that the length of a contract should be determined by commercial factors including the counterparty's reasonable investment horizon. However, to the extent possible, these factors should be assessed at the outset and factored into a market approach. This minimises the chances that the agency will have to directly renegotiate the contract on the basis of unforeseen circumstances.

Because lengthy contracts can be highly sought after, agencies may also be exposed to forceful lobbying techniques by incumbent parties seeking a directly negotiated renewal or extension. This can be a source of corruption risk; for example, when lobbying activities lack transparency or result in preferential consideration.

Lowering bidding costs

If the bidding costs for a particular project are high, relative to the total value of the contract, it may be difficult to generate private sector interest. Where an agency considers that additional competition and overall value for money can be achieved, it should explore the lawful opportunities for lowering the costs of bidding. This may include reducing the number of stages or iterations, reducing the amount of detail required in responses to market-facing documents, or even reimbursing proponents' reasonable bidding costs.

Develop alternative sources

In areas where there is a private sector monopolist or a lack of competition, agencies may be able to facilitate an

in-house bid or some other form of internal provision. The competitive tension provided by an in-house bid may create savings even where the bid itself is unsuccessful.

In situations where there is a shortage of available contractors, agencies may be able to encourage a provider in a related field to expand its operations. In some situations, it may even be practical to invite an international contractor to participate in the process.

The Procurement Board's *Industry Engagement Guide*[11] provides helpful advice for agencies about how to explore the capabilities of potential suppliers while maintaining high standards of probity.

Postpone or cancel the transaction

Agencies should preserve the option of not proceeding with a transaction if direct negotiations cannot be avoided or if the exchange cannot be undertaken on acceptable terms.

The importance of strategic thinking

The criteria set out in this chapter primarily relate to the consideration of factors at a transactional level. However, agencies should also have regard to their overall strategic direction, business strategy and the stated priorities of the NSW Government when considering whether or not to undertake a direct negotiation for a significant transaction or proposal.

To help clarify why a direct negotiation is being contemplated and its purpose, consider the core functions of your agency, the outcomes that are most important to your agency and your agency's goals.

It is the Commission's experience that direct negotiations are less likely to involve corrupt conduct if they are justified in writing; for example, through the development of a business case or procurement strategy. The development of such documents provides a beneficial opportunity for an agency to:

- "take a step back" before any commercial activity takes place
- consider the outcome it is hoping to achieve
- deliberate on the available alternative courses of action
- consider its overall risk appetite, including the risk of reputational damage, counterparty failure and potential impacts on service delivery.

Developing a clear, evidence-based justification for a course of action, that is agreed to early on, will reduce the likelihood of probity concerns arising at later stages of the transaction lifecycle.

An additional concern is that any criteria concerning whether it is appropriate to undertake direct negotiations is open to abuse. Public officials have, at times, made (or been persuaded by) false claims about the existence of monopolies, unique proposals, intellectual property and so on, in order to create the appearance of conformance with the Commission's guidance. Often, this conduct is driven by laziness, lack of imagination or poor planning but sometimes the behaviour is corrupt.

When it comes to the decision to undertake direct negotiations, an agency can defend its decision by:

- ensuring its reasoning is supported by evidence and is not based on mere assertion
- applying its reasoning before the decision and not as a post-hoc device
- considering other approaches and explaining why they are not appropriate in the circumstances
- publishing a notice of its intention to enter into direct negotiations
- documenting the decision-making process, including evidence of research, discussions and communication with senior officers.

The following chapter expands on the practices that agencies should take in order to manage the risks associated with direct negotiations.

[11] Published June 2018.

Chapter 3: How to undertake direct negotiations

Despite the known corruption risks, there may be justification to undertake direct negotiations, as outlined in the preceding chapters. This chapter provides *general* guidance on how direct negotiations can be undertaken in order to reduce those risks.

Before an agency considers the information below, it should have considered and applied the criteria set out in chapter 2 and documented its reasons for undertaking a direct negotiation as part of a procurement strategy or business case.

Consider the probity principles

Direct negotiations can arise in a variety of circumstances, and it is impractical to prescribe detailed procedures for each occasion. In particular, there is a considerable difference in approach that would need to be taken for high- and low-value transactions. However, it is always possible to take a principles-based approach, and the following "probity principles" should govern decisions about direct negotiations:

- fairness
- impartiality
- accountability
- transparency
- value for money.

In the context of direct negotiations, **fairness** requires having regard to all potential parties to the transaction, including any parties that are being excluded by the decision to enter into direct negotiations.

A counterparty should not automatically benefit from direct negotiations just because it is the incumbent, because it is known to the agency, or because it claims to be making the best offer.

Impartiality requires that the process is free of, or at least not adversely affected by, a conflict of interest. In addition to being unencumbered by any private interests, public officials should ensure the decision-making process is free of any actual or apprehended bias. This might require public officials to confront any untested assumptions or latent biases (for example, an assumption that a competitor has no chance of replacing an incumbent).

Accountability entails demonstrating how discretion and resources are used. Most people equate this with being answerable to management but it also involves providing explanations to a range of internal and external stakeholders (which can extend to institutions such as the Procurement Board, NSW Parliament, the courts, the NSW Ombudsman or the Commission) and the general public. Accountability also means that decisions ought to be based on cogent reasoning and that they are consistent with legislation, policy, agency strategy and accepted precedent.

Transparency is a related concept that requires exposing the process to internal and external scrutiny, or at least the possibility of scrutiny. In practice, this involves things like keeping complete and accurate records of meetings and key decisions, cooperating with steering committees, auditors and audit committees and complying with the *Government Information (Public Access) Act 2009*. In addition to being complete and accurate, records also need to be discoverable, which means that they need to be properly titled, classified and stored. It also means that data should be machine-searchable where possible.

The Commission's experience is that officials and counter-parties involved in corrupt transactions strongly resist accountability and transparency measures. They fail to give reasons for their decisions, fail to keep or provide records and seek to minimise the number of people that have visibility over the process.

It should be remembered, however, that some direct negotiations involve managing commercial-in-confidence material or other confidential information such as the government's bargaining position, budget or costings. Transparency, therefore, does not necessarily involve promptly and publicly divulging *all* information about the process.

Obtaining value for money is regarded as a probity principle but it is also a sound commercial practice. By their nature, corrupt deals generally confer unearned or undeserved benefits on parties to the deal – usually to the financial detriment of the public sector. Therefore, to the extent that direct negotiations achieve value for money, corrupt conduct can be minimised.

Naturally, **value for money** is not the same as least upfront cost. The whole-of-life costs and benefits of the transaction should be the agency's primary consideration.[12]

Manage the risks

The Commission's advice for managing direct negotiations is divided into the following sections:

1. seeking authority
2. documenting the process
3. performing due diligence
4. managing conflicts of interest and segregating duties
5. conducting the negotiations
6. agreeing on the price and executing the agreement
7. monitoring the counterparty
8. undertaking post-completion steps.

It should be noted that much of the guidance set out below can be applied to any high-risk transaction.

Seeking authority

Agencies should ensure that the decision to enter into direct negotiations is made at a senior level. Preferably, the decision to negotiate directly should not be made by the person(s) or team that will be performing the negotiations or managing the project or transaction. Because of the gravity of entering into direct negotiations, the Commission suggests that agencies modify their financial delegation policies so that these decisions are elevated to a higher level than would be the case for more routine transactions.

If the transaction is particularly sensitive or controversial, the decision to negotiate directly should be approved by the principal officer of the agency, steering/governance group or the minister or local council, as appropriate.

As noted in the previous chapter, the process is also easier to justify if the proposal to directly negotiate a transaction can be tied to the agency's relevant strategic plan and a procurement strategy or business case. Conversely, a direct negotiation that has no apparent connection with the agency's overall purpose and is not justified by a key document is likely to be viewed as highly suspicious.

Documenting the process

As a general rule, corrupt or unethical officials try to avoid making records that could be used to expose their conduct. Thorough documentation in direct negotiations is therefore critical. All of the key events and decisions described in this chapter and chapter 2 should be documented. Most importantly, however, an agency's course of action can be more easily defended if the following are documented:

[12] The Procurement Board defines value for money as total lifetime benefits less total lifetime costs. Benefits and costs include both monetary and non-monetary factors including opportunity costs. See *Statement on Value for Money* issued by the Procurement Board.

- the rationale for deciding to enter into direct negotiations (as per the criteria in chapter 2)
- the agency's relevant cost estimates, public sector comparator, valuations or other evidence that value for money has been achieved
- the progress of the negotiation process itself and the personnel involved
- the disclosure and management of conflicts of interest
- all other key decisions and the reasons for those decisions.

Agencies should also be aware of the broad requirements in the *Government Information (Public Access) Act 2009* to publish information about various contracts. In particular, s 30(1)(a) of the Act requires the publication of specified information concerning certain contracts for which:

> *there has not been a tender process, the proposed contract has not been made publicly available and the terms and conditions of the contract have been negotiated directly with the contractor.*

The need to demonstrate accountability and transparency

By definition, direct negotiation means that formal processes like tenders, expressions of interest or public advertising do not take place. This also means that procedures such as documented scoring and ranking of proposals do not occur. Therefore, agencies entering into directly-negotiated deals often neglect to create many of the documents that can be used to demonstrate accountability and transparency.

What is the Open Contracting Data Standard (OCDS)?

The OCDS, which is published by the Open Contracting Partnership, facilitates the disclosure of data and documents during contracting stages. The aim of the standard is to encourage transparency and allow analysis of contracting data. It includes a "codelist" requiring compliant organisations to indicate which of its contracts have been awarded without competition (among other transparency obligations).

The OCDS was first published in 2014 and has started to gain in prominence. At the time of writing, the Commonwealth Government was investigating alignment to the OCDS principles. Agencies that are interested in addressing corruption risks should consider voluntarily conforming to the OCDS.

Performing due diligence

It is important to conduct due diligence on the counterparty, its key staff and its offer. In many situations, this should commence before the agency decides to enter into direct negotiations. The level of due diligence performed will typically depend on factors such as the value and complexity of the transaction, the risk to the agency if the counterparty fails, and the agency's reliance on information provided by the counterparty.

Basic due diligence checks[13] involve making enquiries about an entity's:

- structure, ownership, location and trading history
- requisite experience
- senior management
- finances, insurance and credit history
- history of regulatory or legal action, including adverse findings against key personnel
- relevant licences, certifications and accreditations
- supply chain
- media and social media profile.

Among other things, due diligence checks should seek to determine whether any agency staff have a concealed interest in the counterparty (this point is discussed in more detail in the next section).

Due diligence can also entail, for instance, requiring the counterparty to produce information about its internal policies, procedures and anti-corruption controls. The process could also involve making contact with other agencies, regulators or customers that have previously worked with the counterparty. An inspection of the counterparty's premises may also be warranted.

Criminal history checks or detailed security vetting may also be required, which usually requires written consent from the individuals concerned.

[13] This list is illustrative only. There are a number of private sector companies that specialise in conducting due diligence assessments in varying levels of detail.

Tips for dealing with other parties

One agency told the Commission that it conducts a detailed "fit-and-proper-person" assessment of individuals associated with the counterparty when entering into directly-negotiated contracts.

For some transactions, various parties may stand to be paid a finder's or success fee if the deal is completed. Even if an agency is not a direct party to them, it should be cognisant of the risky behaviour that these fees can encourage. A finder's or success fee gives the payee a strong incentive to complete the deal, irrespective of the public interest or the probity principles outlined in this chapter.

Managing conflicts of interest and segregating duties

A majority of the Commission's investigations have involved some sort of a conflict of interest that has been either concealed or mismanaged. A mismanaged conflict of interest coupled with direct negotiations represents a combination of two significant, and possibly inter-related, risks.

Agencies can manage conflicts of interest in a variety of ways. Sometimes simply documenting the conflict is sufficient. However, given the heightened risks associated with direct negotiations, the Commission recommends that agencies seek to exclude conflicted officials from involvement in the process where possible – or at least minimise their involvement.

Some standard methods for identifying and managing conflicts of interest include:

- requiring relevant staff and advisers (from both the agency and the counterparty) to disclose, in writing, any conflicts or confirm that no conflicts exist
- requiring staff to complete relevant training in integrity/probity issues
- incorporating conflict of interest management obligations into the contract (that is, which create rights, obligations and penalties if conflicts of interest are concealed)
- using due diligence checks (discussed above) or data analytics techniques to identify any conflicts of interest
- increasing oversight and tightening governance mechanisms
- requiring the counterparty to refrain from making offers of employment to agency staff members or related parties (or at least requiring all such offers to be promptly disclosed)
- strictly enforcing policies relating to gifts, benefits and hospitality
- confining information to those with a clear need-to-know.

Agencies should also be mindful of the related issue of "capture" or "familiarity bias". If staff members have previously worked with the counterparty, they may be favourably disposed to its interests, even if no conflict of interest exists.

Similarly, agencies should consider biases that might arise from conflicting duties (as opposed to conflicting interests) or key performance indicators (KPIs) that drive unproductive behaviour. For example, a procurement officer might have a delivery timeframe KPI that strongly influences their judgment in favour of finalising a quick deal.

Getting to the truth

It is common for individuals undertaking direct negotiations to be asked to make a written undertaking that they do not have a relevant conflict of interest. Regrettably, this process is sometimes regarded as a "tick-and-flick" compliance exercise, since staff may be concerned that the transaction would be jeopardised if a conflict were to be disclosed. Parties might also be tempted to understate the nature of a conflict (for example, characterising a relationship as a "business acquaintance" instead of a "close friendship").

To address this problem, agencies can consider:

- focusing on personal interests, which can be easier to understand than conflicts of interest
- interviewing key staff in addition to simply asking them to sign a form
- providing face-to-face explanations of what amounts to a personal interest or conflict of interest
- reviewing other sources of information, such as conflict of interest or personal interest registers, gift registers and social media.

Since conflicts of interest are sometimes concealed or understated, it is important that certain duties be segregated to ensure accountability and that no individual has end-to-end control over the process. Each situation will be different but for more complex direct negotiations, agencies might consider segregating the:

- decision to enter into direct negotiations (that is, consideration of the criteria listed in chapter 2)
- performance of due diligence activities
- performance of any benchmarking, price discovery or estimation of a public sector comparator
- formulation of any negotiation strategy
- approval of the price and terms and conditions, or termination of the proposed transaction
- drafting of relevant contracts
- execution of relevant contracts
- final approval of the proposal
- management of performance issues by the counterparty and determination of any penalties for non-performance of the contract.

A simple way to assess whether an individual has excessive control is to prepare a flow chart or process map depicting the various steps in the process and who performs them.

For large or risky transactions, engaging an internal or external probity adviser may also be warranted.[14] Alternatively, formation of a steering committee to oversee the transaction and make key decisions may be appropriate. In some cases, a multi-agency oversight group may be appropriate.

Conducting the negotiations

Agencies sometimes forget to consider the "negotiation" aspect of direct negotiations. Since direct negotiations do not involve a competitive process and, in some cases, involve dealing with a counterparty that has substantial market power, agencies may assume that they cannot pursue favourable terms or develop a mindset that facilitates the granting of unnecessary concessions.

The Commission recommends that agencies adopt many of the same techniques that would be used in a competitive process such as a formal tender. This includes:

- developing an evaluation protocol and formally evaluating, or even scoring, the counterparty's offer
- requiring the counterparty to demonstrate the merits of its product or solution
- developing a budget, cost estimate or public sector comparator
- apportioning risk between parties
- agreeing the scope of work and any As-Is and To-Be analysis[15]
- agreeing how variations will be managed
- agreeing terms for non-performance of the contract, including dispute resolution and termination
- obtaining security (such as a bank guarantee or bond) and obtaining proof of necessary insurances.

Negotiations may produce poor value for money if the agency does not have a clearly formulated desired outcome. Again, while the agency may not be in a strong negotiating position if dealing with a monopolist, it is recommended that some form of negotiation plan be prepared.[16] The plan should set out the structure, format, timing and location of negotiations, who will be present and the agency's bargaining strategy.

The table opposite sets out some of the integrity and commercial issues that could be considered.

In addition to benchmarking the price, the agency should obtain benchmarks for other contract deliverables such as the timeframe, materials used, environmental impact, and so on. Without such project benchmarks, the agency may weaken its bargaining position or unintentionally agree to undesirable concessions that reduce value for money.

For high-value or high-risk direct negotiations it may be appropriate to develop a formal process deed that sets out the agreed steps and behaviours to be followed during the negotiation. Any such deed should be based on legal advice but it could address some of the issues in the table above, measures designed to preserve probity, and a requirement to negotiate in good faith. For simple processes, a basic agreement about the rules of engagement may be all that is required.

Some agencies that regularly undertake complex commercial negotiations have experience in establishing quite formal and comprehensive negotiation processes that entail virtual or physical data rooms, extensive legal advice and multiple rounds of bargaining. It is beyond the scope of this publication to comment on these types of arrangements; however, the relevant point is that complex transactions require additional risk management controls and scrutiny.

[14] It should be noted, however, that engaging a probity adviser should in no way diminish the responsibility that other team members have in maintaining high levels of probity.

[15] An As-Is process is its current state; a To-Be process is how it will be in the future.

[16] A useful template is available from the Procurement Board's website. While this template is designed for procurement activities, it can be adapted for any type of negotiation.

Agencies should also be aware that acting in the public interest involves considering both the financial side of any deal as well as those harder to measure social benefits (for example, the benefits of open space, healthier communities or reductions in crime). Typically, a private sector counterparty will not place as much emphasis on these social outcomes.

Agreeing on the price and executing the agreement

Once the negotiation phase is complete and successful, the agency needs to finalise a formal agreement with the counterparty (usually in the form of a contract).

The Commission often receives complaints about directly-negotiated transactions that allegedly confer significant financial benefits on the counterparty.

Integrity issues	Commercial issues
• Ensuring that the negotiations are accurately minuted, or even recorded, and that at least two agency representatives are present. • Ensuring that the negotiations proceed with the necessary degree of formality and are not, for instance, conducted in a social setting. • Requiring any staff with probity-related duties to be present. • Following up on key points in writing. • Ensuring that the agency's budget, valuation, public sector comparator, Best Alternative to a Negotiated Agreement (BATNA)[17] or other bargaining-related information is not divulged or compromised. • Ensuring that the counterparty's intellectual property is adequately safeguarded and confidentiality agreements are in place where appropriate. • Ensuring that any contracted members of the agency's team are properly screened and do not have conflicts of interest or that a conflict of interest is declared. • Agreeing on the precise roles and delegations of the members of the negotiating team. • Conducting basic due diligence on the members of the counterparty's team. • Requiring the counterparty to refrain from lobbying or approaching other agency personnel (or elected representatives) outside of the agreed negotiation protocol. • Where lobbyists are used, ensuring that both the *Lobbying of Government Officials Act 2011* and related code of conduct are adhered to.[18]	• Addressing any gap in seniority, experience and knowledge between the agency's negotiating team and the counterparty's team (including both technical skills relating to the transaction as well as negotiation skills). • Agreeing to items that are on or off the table. • Developing a walking-away point and a BATNA. • Addressing budget issues such as developing cost benchmarks and setting cost upper limits. • Requiring the counterparty to provide relevant documentation ahead of any meetings so that it can be analysed by agency staff. • Refraining from making any verbal, binding commitments during face-to-face negotiations. • Determining who will own intellectual property and how it will be paid for and used. • Where feasible, preparing for the likely arguments and supporting material that the counterparty will rely on.

[17] BATNA is an agency's Plan B or best course of action if negotiations fail.

[18] The Lobbyists Code of Conduct established under the Lobbying of Government Officials (Lobbyists Code of Conduct) Regulation 2014 contains principles that could be applied even where registered lobbyists are not involved in the negotiation process.

This often involves complaints about leases and tenancies, land sales and grants as well as more routine procurement activities.

Before signing any contract, the agency should satisfy itself that the consideration to be paid is consistent with its original budget, estimate or valuation. Where an agency can demonstrate that attempts have been made to secure reasonable value for money, despite the apparent absence of competition, it can more easily counter perceptions of corrupt conduct.

The Commission also recommends that, wherever possible, agencies use their own contract templates or government-endorsed templates (such as those approved or referenced by the Procurement Board) instead of contracts prepared by the counterparty.

In any case, the executed agreement should ensure that the counterparty:

- is bound by the agency's relevant standards of conduct, as set out in documents such the code of conduct or statement of business ethics
- does not seek to avoid or dilute accountability mechanisms, such as compliance with the *Government Information (Public Access) Act 2009*
- cannot unreasonably resist attempts by the agency to verify performance or obtain relevant information (for example, by including a right-to-audit clause)
- cannot novate, subcontract or reassign functions under the contract without the agency's consent.

As noted in the section above, the risk of corruption can be lowered by segregating the personnel that negotiate the terms of the transaction from those that draft and execute the contract.

The point at which a direct negotiation is finalised can also serve as a final gateway point at which the agency can obtain assurance that probity principles have been adhered to and that the proposed outcome is consistent with the initial approval to enter into direct negotiations.

Monitoring the counterparty

Some direct negotiations relate to discrete, time-limited transactions that do not require the behaviour of the counterparty to be closely monitored (for example, sale of a parcel of land). However, in situations where the counterparty is delivering an ongoing service for, or on behalf of, the agency it is important for the terms of the contract to be monitored and enforced.

This is important because, in situations where the agency cannot realistically award the work to any other party, it may be tempted to relax its normal contract management standards.

Monitoring the work carried out by contractors is always important. However, in cases where a counterparty has little to fear in terms of competition, the need to scrutinise performance is especially important. For some projects, it may be practical to impose a number of stage gates or "go / no-go" decision points that can be used to track progress and prevent the risk of scope creep.

Agencies should also ensure that an apparent lack of competition or bargaining power is not reason to forgo the usual recordkeeping and documentation processes. Any proposed variations to the project should be carefully scrutinised, especially if initiated by the contractor.

Negotiation skills matter

Since most public officials are used to transacting with the private sector as part of an open and arm's length competitive process, they may not have well-developed negotiation skills. Among other things, successful negotiation can involve dealing with assertive counterparties, the need to de-escalate conflict and address tendentious arguments.

Where this is the case, an agency may wish to engage professional negotiators to advise or act on its behalf. However, as noted elsewhere in this publication, agencies should satisfy themselves that any contracted advisers are not affected by conflicts of interest and do not have access to confidential information that is not required for their job.

The Commission also recommends that the fees paid to professional negotiators not be contingent on finalisation of a contract. Negotiators should not have a financial incentive to make a deal that is not in the public interest.

Undertaking post-completion steps

Just like any other aspect of an agency's business, high-risk direct negotiations should be subject to various types of scrutiny, including:

- inclusion in the internal audit program, which could include triggering right-to-audit or open-book clauses in the contract that require the counterparty to produce information and cooperate with auditors
- review by the audit and risk committee

- review as part of routine management reporting, risk management procedures and/or project management office oversight
- financial reconciliation
- post-implementation reviews or lessons-learned processes
- benefits realisation assessment or other methodology for determining benefits over the life of the contract.

Due to the significant benefits conferred by direct negotiations, it is important that counterparties understand that they have something to lose should they engage in any form of misconduct.

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