



29 March 2017

Ms Lynley Ducker
Committee Secretary
Joint Select Committee on Government Procurement
PO Box 6021
Parliament House
Canberra ACT 2600

By email: JSCOGP@aph.gov.au

Dear Ms Ducker,

JOINT SELECT COMMITTEE ON GOVERNMENT PROCUREMENT

Thank you for the opportunity to make a submission to the Joint Select Committee on Government Procurement.

The Australian Small Business and Family Enterprise Ombudsman was established in March 2016 to advocate for and assist small business and family enterprise. Across both advocacy and assistance functions during the 12 months of our operation we have found that federal government procurement processes generate multiple issues of concern to Australian small businesses.

Our comments below are informed by this experience and correspond broadly to paragraphs (a) and (f) of the Committee's terms of reference. We commend Government on the recent promulgation of the Commonwealth Procurement Rules (CPRs) but believe there is much more that Government can do, particularly using Government procurement as a mechanism to grow small businesses in Australia.

Small business and government procurement

Small businesses employ almost half of Australian workers¹ and create a substantial proportion of new jobs. Many Australian small businesses have the capacity to deliver to government and are competitive in terms of price and quality. Research has shown that small business participation in government procurement is therefore a useful lever whereby government can support this vital sector in jobs and growth.²

¹ Small businesses (0–19 employees) employ 45 per cent of Australian workers in selected private sector industries (ABS cat. No. 8155.0).

² Ferraz C, Finan F and Szerman D, 2015, "Procuring Firm Growth: The Effects of Government Purchases on Firm Dynamics" National Bureau of Economic Research, NBER Working Paper No. 21219, May 2015 [<http://www.nber.org/papers/w21219>]

The Commonwealth spend is one of the largest procurement spends in Australia. Between \$50 billion to \$60 billion is spent annually by the government on procurement exercises (anywhere between 65,000 to 80,000 contracts).³

In 2015–16, the Commonwealth spent \$56.9 billion through 70,338 contracts. The Government sets a target for Small and Medium sized Enterprises (SME) participation at 10 per cent of Government spend by contract value. It is noted that this is comparatively low and unambitious when compared to targets set by overseas jurisdictions. The UK has a target of one third of all Government spend by 2020 going to small business.⁴ The US Government has a long standing preferential treatment policy which targets that 23% of federal contracts by value to go SMEs.

In 2015–16, and in spite of the Government's low target, SME participation was 24 per cent by value (\$13.7 billion) and 61 per cent of contracts (42,737 contracts). Small business (based on the Australian Bureau of Statistics definition) participation is smaller at 10 per cent by value (\$5.5 Billion) and 33 per cent of contracts (22,883 contracts).⁵ These do not tell the whole picture, as they only represent direct engagement with small businesses and does not reflect the input or contribution small businesses have in the wider Government supply chain.

Despite a steady rise in the Government procurement total spend, the total amount won by SMEs has remained relatively steady by total value. SME participation as a percentage of total spend has been declining over the last few years.⁶

Year	FY16	FY15	FY14	FY13	FY12
Procurement Spend (\$B)	\$56.9	\$59.4	\$48.9	\$39.3	\$41.8
SME Participation by Value (\$)	\$13.7	\$16.6	\$16.6	\$12.6	\$16.3
SME Participation by Value (% share of total)	24%	28%	34%	32%	39%
Movement on prior year's share (ppts)	- 4% ↓	-6% ↓	+2% ↑	- 7% ↓	

The Ombudsman is interested in addressing the declining share of direct SME procurement spend as well as the treatment of SMEs in the Government supply chain. Our research and interactions with small businesses have highlighted a number of barriers to small business participation in government procurement processes.

³ Department of Finance, Statistics on Australian Government Procurement Contracts, <http://www.finance.gov.au/procurement/statistics-on-commonwealth-purchasing-contracts/>

⁴ See Big opportunities for small firms: government set to spend £1 in every £3 with small businesses at Big opportunities for small firms: government set to spend £1 in every £3 with small businesses

⁵ Department of Finance, Statistics on Australian Government Procurement Contracts, <http://www.finance.gov.au/procurement/statistics-on-commonwealth-purchasing-contracts/>

⁶ Ibid.

These include:

- **Red-tape:** Small businesses do not always have the resources required to complete burdensome tender or panel documentation.
- **Lack of information:** There is a lack of easy-to-find information about contract opportunities and how to engage with the tender process.
- **Power imbalance impacting access:** SMEs are more likely to accept a role as a sub-contractor on a government procurement project to be able to access Government procurement opportunities. In doing so the business will be subject to (and likely accept) restrictive contractual terms, higher levels of risk and difficult commercial relationships to ensure access and continued opportunities for Government procurement work.
- **Perceived risk:** SMEs can be perceived to be riskier than larger suppliers by Government employees, particularly when tendering for the delivery of larger contracts. 'Safe' procurement decisions may result in new or innovative small providers not being awarded government contracts.
- **Value for money assessments:** SMEs can be disadvantaged by being unable to offer the very lowest price, even when the business is competitive overall and would succeed if broader value-for-money criteria were used.

As a result, small business participation in government procurement tends to be indirect as subcontractors or concentrated in peripheral and/or supporting activities (the prevailing view that small businesses tend to help Government with "sandwiches and websites").

The top five categories which SMEs tend to dominate are:⁷

Category	SME Participation %	Category % of Total spend
Editorial and Design and Graphic and Fine Art Services	87	0.8
Management & Business Professionals & Administrative Services	65	12.3
Public Utilities and Public Sector Related Services	60	0.7
Farming & Fishing & Forestry & Wildlife Contracting Services	54	0.5
Financial and Insurance Services	47	0.5

Aside from Management and Business services, these categories account for a relatively low share of total spend (each less than 1% of total Government spend).

Indirect SME engagement with government procurement

Small businesses are increasingly telling us that many Commonwealth Government departments and agencies are seeking to reduce the number of contracts handled directly by agency staff. Instead, agencies are increasingly relying on larger firms to manage and deliver parcels of government work as well as manage associated supply chains on their behalf. These contract arrangements, where a prime

⁷ Ibid.

contractor or first tier contractor is employed, are sometimes called Management Service Provider contracts (MSPs) but can also be called strategic partnering arrangements (SPA) or managing contractor (MC) arrangements.

Such arrangements have many benefits for Government agencies particularly under current public service staff caps. Subcontracted small businesses are often left unable to access protections and remedies that would have been available to them had they been directly contracted to the Commonwealth. For example, payment terms, including terms for progress payments, that are set by government do not flow on to small business subcontractors, nor do other terms and remedies such, such as access to the Commonwealth contract representative. We note that some progress to address some of these issues associated with MSPs are being recognised, particularly in the Department of Defence's new Defence Support Services (DSS) panel, though it will be sometime before the effect of these changes is understood.

Another context in which small business subcontractors are often unable to access rights and protections available under the head contract is that of insolvency on the part of the prime contractor. Several examples have been brought to us where the prime has become insolvent to the detriment of many smaller subcontractors. This has been most telling on the issues associated with the building of the new Ben Chifley Building in Canberra which left many subcontractors insolvent and owed money.⁸ In some cases illegal conduct is alleged, but even where there is no such allegation, small subcontractors are highly vulnerable and we are aware of cases where they have missed out on payment for their contribution to government projects.

Government responses to this have reflected the fact that the Commonwealth has had no direct contractual relationship with any affected party and the Commonwealth has still received the new building as required and paid for. The question is: At what cost has this been achieved particularly to the small businesses in Canberra and surrounding economy? This is only one example, there are many others: such as that raised by the Federal Member for Gilmore concerning the Defence facilities for AIR9000 Phase 8 at HMAS Albatross in Nowra, NSW.

In such cases the impacts may be exacerbated by small business contractors' failure to recognise and follow relevant security of payments legislation or contracting standards and conditions which do not always flow through from the head contract to subcontracts.

Government work is often attractive to small businesses partly because of a belief (which may be encouraged by primes seeking subcontractors) that government can be trusted to adhere to certain standards (e.g. safe working conditions, eventual payment for services rendered) in dealings throughout the supply chain. Where a small business is working on government property to deliver outcomes for

⁸ For example, see Australian Small Business Commissioner. 2014. ASIO Building: the Costs of Poor Contracting Practices (Report to the Minister for Small Business). Available at <http://www.asbc.gov.au/sites/default/files/ASBC%20-%20ASIO%20Building%20Report.pdf>.

government, it is understandable that the small business may develop and act on an expectation that it will be dealt with under the same conditions as apply to the head contractor, for example by not taking steps it might otherwise take to mitigate risk. Depending on the circumstances a small business might even argue that it is responding to an implicit representation on the part of government and/or the prime that should be honoured for equity's sake.

Other issues and risks arising from smaller entities indirectly engaging in government procurement through supply chains include:

- **Lack of visibility – responsibility and accountability is delegated:** Government does not have visibility of the engagement of SMEs as subcontractors on Government procurement exercises.⁹ This effectively transfers responsibility to the prime contractor for ensuring quality and regulatory compliance.
- **Lack of visibility – risks to delivery:** Lack of visibility can also pose a risk to delivery. For example when a critical supplier several links down the chain runs into difficulties and the procuring agency is not made aware of the issue.
- **Lack of pricing transparency:** Lack of pricing transparency through the supply chain can result in subcontractors earning less and/or inflated prices charged to government. For example, a subcontractor may be paid \$200,000 to provide the key component in a contract for which the government is charged \$2 million.
- **Power imbalance resulting in inequity:** More sophisticated primes or second level contractors can abuse the imbalance of power to transfer the responsibility, risk and cost for variations on to smaller subcontractors and secondary subcontractors.
- **Unclear roles and responsibilities:** Complex contractual arrangements can lead to misunderstandings or conflicts. For example, where a subcontractor undertakes work at the explicit direction of government personnel this can lead to conflicts between the subcontractor and the prime contractor if roles aren't clearly defined.
- **Dispute resolution:** any disputes between prime contractors and subcontractors become a commercial contractual matter and not the responsibility of the procuring agency, even though small businesses may not have the power and resources to effectively resolve disputes with larger entities.

⁹ The UK surveys large suppliers in order to have visibility of SMEs engaged with government procurement through the supply chain. In 2014–15, it was found that indirect SME government spending was 50 per cent higher than direct SME government spending.

International initiatives to address procurement problems

Governments in other countries have taken a number of steps towards creating a level playing field for small business to participate in government contracting, directly and as part of the supply chain. These reforms have focussed on increasing transparency, improving processes, overcoming delays in payment and improving dispute resolution.

Governments are shortening payment times for suppliers (including subcontractors) to under 30 days in the United Kingdom¹⁰, the United States and Ireland. The Central Government Prompt Payment policy, first outlined in 2010 requires most UK Government departments and agencies to pay 80% of undisputed and valid invoices within 5 days with the remainder paid in 30 days. Ireland introduced a 15 day payment policy for Government departments and agencies in 2009. This policy committed the Irish Government departments to pay suppliers in 15 calendar days from receipt of an invoice.

The US federal government launched QuickPay in 2011 to accelerate payments by federal agencies to small business contractors to within 15 days. This policy was expanded to include subcontractors in 2012. A recent study showed a positive impact of this reform on employment and wage growth.¹¹ SupplierPay is another US government initiative whereby companies commit to pay small business suppliers faster or else help them get access to lower-cost capital. Participants recognise that a healthy supply chain is good for business and that when small businesses get access to working capital they use it to invest in new opportunities, equipment and jobs.

To improve indirect engagement with SMEs, the UK focussed on project bank accounts for public works projects. These accounts allow fast payment to SME subcontractors, with SMEs no longer needing to wait for higher tier contractors to pay them. This move also improves transparency and certainty of payment for small businesses and reduces the number of payment disputes which can be costly for all parties. A trial of Project Banks Accounts on Commonwealth projects was a recommendation (recommendations 29-31) from the Senate Economic References Committee Inquiry into Insolvency in the Australian Construction Industry report from December 2015.

The UK government recognised the need to approach dispute resolution anonymously. The Mystery Shopper service, introduced in 2011, conducts spot checks on government buyers and allows current and potential government suppliers to raise concerns anonymously about unfair public sector procurement practices. The results of Mystery Shopper investigations are published, including government changes to current or planned procurements, or the supplier gaining a better understanding of the procurement process.

¹⁰ Regulation 113 of the Public Contracts Regulations 2015. This requirement, introduced in 2015, requires payment of undisputed invoices within 30 days throughout the government supply chain.

¹¹ Barrot, J.-N. and R. Nanda. 2016. Can paying firms quicker affect aggregate employment? Working Paper 17-004. Cambridge: Harvard Business School.

Increasingly, the consideration of social value aspects in procurement (as part of a value for money assessment) is a focus of governments. The UK Public Services (Social Value) Act 2012 came into force in January 2013. It requires public bodies to consider choosing providers based on the social value created in an area and not on cost alone.

The UK government have introduced a number of initiatives to reduce the burden on suppliers tendering for government contracts and improve access/awareness of government procurement opportunities. For instance the UK government:

- has removed pre-qualification questionnaires for contracts below a certain value and uses a standardised questionnaire for higher value contracts;
- introduced a “comply or explain” requirement for procurement officers to break contracts into smaller lots;
- introduced Contracts Finder, an online portal for advertising public sector contract opportunities;
- established Crown Representatives for small to medium enterprises and volunteer, community and social enterprises respectively. The goal is to build a more strategic dialogue between government and small business.

Recommendations to improve Commonwealth procurement and maximise its benefits to small business and the Australian economy

When government agencies use contractors to manage the supply chain and therefore do not have a direct contractual relationship with subcontractors, the government has a choice:

- It can keep subcontractors at arm’s length and wash its hands of responsibility for their treatment, insisting that any disputes are purely contractual matters to be resolved by the parties. This approach leaves small businesses unable to access protections and remedies that would have been available to them had they been directly contracted to the Commonwealth.
- Alternatively, government can take a hands-on approach to ensuring healthy supply chain interactions that permit small businesses to participate and contribute. It already does this for matters it considers critical such as security.

In our view, engaging a contractor to manage the supply chain should not be taken to absolve the procuring agency of all responsibility. In seeking to implement the Commonwealth procurement framework, agencies should follow leading practice, set the standard for acceptable management behaviours and be a good corporate citizen. This should be reflected in the standards and practices required of supply chain participants as well.

One approach that we have previously recommended is including in the conditions of contract in the Commonwealth Contracting Suite a condition of subcontracting that alerts subcontractors to our role in assisting small business. This would enable them to access our help with dispute resolution should they need it and build upon an existing service at no additional cost to the Government.

Other measures could include:

- developing codes of conduct for prime contractors in different industries;
- requiring managing contractors to report all layers of contracting to the procuring agency (the UK does this through a survey of large suppliers). This reporting should include the value of subcontracts in order to maintain transparency regarding the price paid to subcontractors versus the price charged to government for key delivery components;
- developing a standard form contract to be used for all subcontracting. This could include a clause in the head contract stipulating that all rights and protections afforded to the contractor—including those related to payment terms and dispute resolution—must be replicated in any other contracts related to the same subject matter;
- establishing project bank accounts for which the procuring agency remains responsible in order to retain leverage in the event of any dispute between supply chain participants;
- establishing an initiative similar to the United States' SupplierPay, in which larger businesses pledge to ensure fast payment to small subcontractors;
- including directives in the CPR or related policies giving effect throughout the supply chain to the principle that where an agency or contractor is best placed to manage a particular risk, it should not seek to inappropriately transfer that risk;
- establishing a Commonwealth small business procurement advocate and secret shopper function akin to the UK's Crown Representatives and Mystery Shopper. This advocate would have powers to investigate and resolve any issues raised and to publish outcomes in a form that enables public scrutiny and can be used to inform any further dispute resolution or court proceedings, alternatively this function can be added to our office;
- training for government personnel to be sensitive to contracting and subcontracting arrangements in a particular project in order to avoid contractors and the contracting agency giving conflicting instructions to subcontractors.

To positively influence behaviour within the supply chain, government needs to maintain oversight of the relationships between contractors and subcontractors. To do this it needs a means of gathering and integrating relevant information. At present, access to data about small business participation in Commonwealth procurement processes is limited. AusTender data includes every contract \$10,000 and above, but it does not distinguish between small business and larger businesses.

Hence, we recommend that the Commonwealth should become leaders of procurement best practice to improve the quality of information available about small business participation in government procurement processes. At present, the United Kingdom government is considering whether to establish an integrated digital platform for procurement in order to improve data about the procurement process. We suggest that the Commonwealth government should give consideration to a similar initiative. Acknowledging the magnitude of the task, we suggest a first step would be for AusTender to begin collecting information about business size.

If the Commonwealth chooses to pursue any of our recommendations above, it will be important to strike an appropriate balance between protecting small business from unlawful or unacceptable behaviour and preserving freedom of contract. The ultimate aim is to encourage innovation and competition, not to stifle it or to add significant compliance costs for any contracting party. To ensure that the results of any measures to reduce the barriers faced by small business bidding for public sector work are uniform across the board, ideally they should be adopted across all agencies, not left to the discretion of individual agencies or procurement teams.

Conclusion

Since commencement, the Australian Small Business and Family Enterprise Ombudsman has taken an interest in government procurement matters. We believe that increasing participation by small business will in turn increase competition for government work and lead to better returns on public spending. For this reason and for the sake of strengthening the vital small business sector of our economy, we see it as a high priority to advocate across all levels of government for improvements. This will enable small businesses to participate on a level playing field, both directly and as subcontractors, within the supply chain. In the meantime, we will continue to assist small businesses to resolve any disputes they may encounter in this area.

Should you wish to discuss this submission further, please contact me or James Strachan on 6263 1535 or james.strachan@asbfeo.gov.au.

Yours sincerely,

Kate Carnell AO

Australian Small Business and Family Enterprise Ombudsman