8. Paying advisors for their advice

Outline of Module

What this Module does:
As indicated in Module 7, the appointment of advisors should generally follow a competitive tendering process. This module considers the ways in which advisors can be remunerated once they have been selected. In particular, it looks at the appropriate mix of success fees, time and material contracts and fixed fee contracts. The module also covers ways of rewarding innovation and discusses the issue of how risks should be allocated and contracts structured.

Who should read this Module:
This module should be read by managers of major reforms who are involved in design or negotiation of major contracts with advisors. This group of officials ranges from middle level civil servants located in the PPI unit or office heavily involved in recruiting advisors right through to senior officials who might be required to approve and sign contracts, as well as officials with financial and procurement responsibilities.

Substantial funds are spent on advisors. Managers of major reforms need to consider how best to structure those contracts to maximize value for money. This module describes a number of different approaches, and the situations under which they are appropriate.

8.1 Fixed fee contracts

For the purposes of PPI projects, the majority of advisors - economists, engineers and perhaps legal advisors - will normally be retained on contracts which either give them a fixed fee for delivering specific outputs, or which pay them on a time and materials basis for providing specific inputs.

The main risks in purely advisory contracts relate to the cost of the services and the quality of the output. Fixed fee and time and materials contracts allocate those risks differently. Fixed fee payments place the majority of risk related to costs on the advisors and, as a result, there will be an incentive for advisors to take short cuts on quality, with associated risks for the government.

Because fees are fixed, after the contract is won the company or consortium may have an incentive to reduce inputs against levels they had originally planned. They can do so by reducing the time input, or using lower cost staff, or by reducing 'out-of-pocket expenses' such as travel costs to increase the profit margin. These incentives to reduce inputs need to be offset by an ability to enforce quality standards.

The greatest difficulty under fixed fee contracts is therefore assessing quality. There are a number of ways of strengthening the government's ability to assess quality. Governments could:

- **Rely on companies with a high reputation** All purchasers of advisory services face the same problem: that there are many providers of services, but it takes

time to assess the quality of the advice they provide. The normal response in markets of this sort is to rely on reputation as a signalling device, perhaps through the use of Past Performance References (PPRs). Where companies have a high reputation, they have more to lose if quality is low.

- **Rely on lead advisors** Where lead advisors have strong incentives to deliver, they will also want to ensure that sub-consultants perform promptly and well. However care should be taken to avoid potential conflicts of interest. In particular, sub-contractors often see lead advisors, rather than the government, as the client and this could lead to a lack of clarity in sub-contractors' objectives.

- **Use peer review** The market for advisory services is highly competitive. Another firm can be retained to review the quality of what has been produced. This normally requires relatively little time or expense. It cannot be used to fine-tune quality (since fine differences could be explained by difference of approach among the two companies). It can be used to ensure that low quality advice is not being provided, or important issues completely missed. However, the competitive nature of firms may raise the risk of undue criticism. Moreover, an outright condemnation of work from a peer reviewer can undermine the public confidence in a project and delay project implementation. As a result, peer review is often provided by donor agencies or governmental peers so as to guarantee objectivity.

- **Hire two firms to perform the same task** Where advisors' input could be crucial to the success or failure of the proposed reform, governments might consider using two sets of advisors to undertake the same task. For example, this might be an option where asset valuations are needed.

All of these potential quality control mechanisms are of lesser importance that careful selection and contract monitoring. A fixed fee contract works best when if output is clearly defined, quality can be measured and the advisor can control the risks associated with delivering the output. This is likely to be the case for most of the advisors outlined in Module 3, with the possible exception of the financial and legal advisors.

Recommendation 8.1: Fixed fee contracts should be used where the output is clearly defined and measurable. They may be combined with control mechanisms to enhance quality standards.

8.2 Time and material contracts

Time and materials contracts transfer cost risk to the government. Therefore, they need to be matched with systems for managing total fee costs and quality of output. However, the incentives to maintain high quality are greater than under fixed fee contracts. Companies have incentives to put more resources, especially more senior ones, onto the job and this will often result in higher quality.

Time and materials contracts are generally awarded for assignments in which the total input is difficult to define at the stage when the project is bid. This tends to be true of activities that come late on in the transaction. For example, the amount of legal

drafting will not be clear until other stages of the project are completed and will be affected by the response of the bidders to the proposed contract.

There are only a limited number of ways to manage cost risks. Possibilities include:

- Agreeing in advance to a reduction in unit fee rates if the volume of work exceeds an agreed level. Companies are often willing to accept lower fee rates for jobs which give them a large volume of work in a short period of time.

- Agreeing in advance to a cap or ceiling on the total billings. While this approach limits government risk, final cost may be difficult to anticipate and the consultant will be incentivized to bill up to the cap.

- Seeking, where possible, to transform open-ended time and materials contracts into fixed fee contracts for particular outputs. It may be possible to define new outputs and agree a cost for meeting them as the transaction proceeds.

- Ensuring that the time spent is carefully monitored for each individual team member and approved by the project manager – for example advisors might be required to provide an hourly breakdown of the time devoted to individual tasks or a monthly invoice that is subject to mutual agreement. This requirement for careful, detailed monitoring imposes additional costs in itself.

In practice, as major transactions near finalization it may prove very difficult to put any of these mechanisms in place to limit costs. It may also be difficult to know who performed each task and to determine the work undertaken by each team member. However, both investors and the government have an incentive to reach financial closure as rapidly as possible. Hence real time constraints may limit the total cost of any open-ended time and materials contracts.

Recommendation 8.2: Officials should use time and material contracts where it is difficult to determine the exact range of outputs that will be required. Nevertheless, as far as possible, the TOR for work undertaken on a time and materials basis should attempt to detail the proposed time and material input.

Although termed 'time and material contracts' many technical assistance contracts are de facto fixed fee contracts. Much of the work may be undertaken offshore and it is not possible to assess who is doing it or how long it takes. In practice, the firm gets paid provided the output is delivered to acceptable quality by the due date. At the same time, in appearance, they are time and materials contracts because bidders are required to build their cost proposals based on time inputs of individual staff; related fee rates; and other costs.

This has a number of advantages. If quality is not easy to assess, then inputs by appropriately qualified staff may be one proxy. Gross divergence from agreed inputs can then be monitored. The individuals named also have an interest in preserving their personal reputation. The contracts also make it easier to negotiate further work, since fee rates have been agreed upon.

Recommendation 8.3: Where advisors are paid for output (and so apparently a fixed fee), details of their proposed inputs will assist contract management.

8.3 Bonus and success fees

Contract theory shows that risks should be allocated to the party best able to manage them. Payment of success fees is the most usual form of substantial risk transfer under advisory contracts. As the term implies success fees result in advisors being paid a fee based on a successful outcome. The definition of a successful outcome may have a number of dimensions reflecting monetary values (such as the market value of a transaction or level or tariffs) or non-monetary objectives, such as the completion of a transaction by a particular time.

Success fees may be a lump sum, a share of the sale or some other value, or a share of value above a target level. In addition to the success fee, it may be appropriate to accompany the contingent payment with a retainer. The balance between the two will reflect the extent to which the government wishes to incentivize their advisors, and the extent to which a successful outcome is under their control. Common estimates for the size of success fees are in the range 0.2% to 3% of the transaction value, depending on the country concerned, the size of the transaction and the market conditions.

8.3.1 Measuring success fees

Success fees are appropriate when:

- it is possible to measure and quantify success in meeting government objectives;
- when success is at least partly related to the efforts of the advisors involved; and
- when it does not generate a conflict of interest.

Within advisory services, success fees are usually reserved for the successful completion of a PPI transaction (e.g., sale of a government owned company). By that stage it is generally possible to measure success in dollar terms, and success fees give an incentive to increase sale revenues. The value of other advisory work cannot normally be measured directly.

It is a mistake to base advisors' incentives on sale revenues at an early stage. In general, governments have objectives that are not purely financial. The structure for private sector participation should reflect those broader objectives. Once that structure is in place, the government's objectives may become more purely financial – to maximize sale revenues (or minimize required subsidies) within an agreed framework.

The power sector provides a clear example. Many electricity reforms to-date have created several generation companies, and introduced competition in generation, as a way of protecting consumer interests. However, sale value of generation assets would be higher if competition were not encouraged, and if a smaller number of generating companies (or only one) had significant market power. Introducing an incentive based on sale value for advisors' remuneration at too early a stage runs the risk that the government's objective of increasing competition is neglected, as it does not increase sale value (and is likely to reduce it).

Recommendation 8.4: Success fees should generally be limited to the final transaction stage of advice. By that time the government's objective is to bring the project to financial closure. Success fees should not be introduced before the broad structure of sector reform has been determined.

8.3.2 Restricting the use of success fees

Success fees should be reserved for advisors whose efforts will have a significant impact on sale value or other definable government objectives. The bankers handling the sale are the most directly concerned. Bankers can affect sale value by:

- working to attract a large number of qualified bidders; and
- by ensuring the transactions team delivers appropriate and timely information to bidders.

The largest trade sale in the world to date was during the Victorian power sector reforms and demonstrates the ability of bankers to generate interest in a sale and increase the revenue to the government. Commenting on the power sales during the sale period, the Treasurer of Australia wrote:

"…trade sales were vigorously contested. Buyers who at first asked 'what is this business worth?' were by the close of bids asking 'what do we have to do to win'." [10]

Bankers played a major role in achieving that shift in bidder attitudes, assisted by a process with a high degree of transparency and disclosure. The strong preference of the government for fully financed bids enabled close adherence to the timetable indicated in advance, also increasing confidence.

More generally, a handful of other key advisors may also play a role in changing attitudes. Legal advisors tend to be heavily involved in final negotiations with bidders. Non-banking financial advisors may also be influential.

The decision of which advisors should be provided with incentives through success fees needs to be taken separately for each transaction. This decision should be reached by asking the following sorts of questions:

- Is success or failure of the project directly related to the performance of advisors?
- Are there risks that could affect the outcome which are beyond the control of advisors?
- Will the lead contractor be able to extract the best performance from their sub-contractors in the absence of success fees?

If the answers to any of these questions is 'yes', then officials should think carefully about using success fees.

Recommendation 8.5: Success fees should be reserved for the small number of advisors whose efforts can have a significant impact on value.

8.3.3 Alternative approaches to structuring success fees

Success fees need to give advisors incentives to improve the result through increasing their efforts. That requires a decision on two parameters: the measure of value against which advisors will be rewarded and the structure of the incentive. The basis for such a decision is an estimate of what result is achievable, and what more could be achieved through increased effort.

[10] "The politics of privatisation in Victoria", Alan Stockdale, in Privatisation International, November 1999.

Sale of the Victoria Plantations Corporation

Australia's Victorian Plantations Corporation (VPC) was a state owned enterprise. VPC owned and managed 108,000 hectares of softwood plantations and 7,000 hectares of hardwood plantations, covering an area of around 166,000 hectares. In 1998 the Government of Victoria began preparing to sell VPC. Independent estimates of market value were A$177 to A$246 million, depending on the discount rate used.

Total advisory costs for the sale were around A$7million. A transaction advisor was retained at an estimated cost of A$4million. The transaction advisor was entitled to a further performance bonus of A$0.5million provided that the sale was finalized no later than March 1999 and the sale proceeds exceeded A$350million. Hence the definition of success that was used had two dimensions to it – time and money.

The sale of the business was announced in November 1998. Total sale proceeds were A$550million.

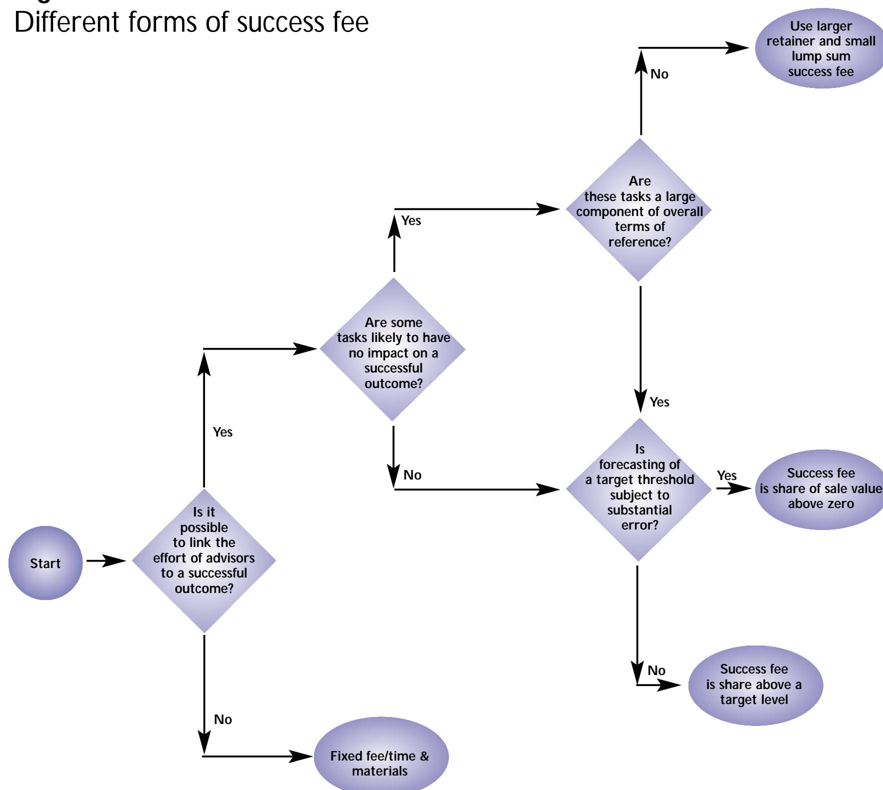
Source: General Report on Ministerial Portfolios, May 1999

Achieving a target above a certain value

One approach to establishing the basis for success fees was discussed in relation to the sale of the Victoria Plantations Corporation. A financial model can be used to estimate possible market values, based on discounted future cash flows. It is important that this estimation is carried out by independent experts; in other words, advisors who have nothing to gain from forecasting any particular valuation. The transaction advisor is then given an incentive to exceed the original valuation or expected payment.

Figure 8-1

Different forms of success fee



Unfortunately, as the example illustrates, forecasting is not an exact science and hence the approach generates the risk that the fees to advisors will reflect forecasting errors rather than their efforts to increase the market value. Not withstanding this risk, however, a target approach has the merits of being defensible and establishing appropriate incentives, so far as can be done with limited information before the sale.

Achieving a positive sale value
An alternative to setting a target is to offer bidders a share of sale value[11] above zero, rather than sale value above a target. This approach requires less analysis. The disadvantage is that the asset or business being sold may well have a positive value that could be realized regardless of effort by the advisor. If they perform poorly they are still receiving a substantial payment. In theory this should be reflected in the bid price (advisors will bid less in fees if they expect to receive more in bonuses). In practice, it may prove harder to defend following the sale.

Lump sum or sliding scale?
The structure of the incentive can be a lump sum, as in the Victorian Plantations example given. Alternatively, advisors can be given a sliding scale. This would give them a share in sale proceeds, or in sale proceeds above a target figure where the share is increased the more the advisor exceeds the target.

In theory, advisors should reflect the expected value of success fees in their bids. However, estimating sales value and thus success fees is difficult, particularly at the early stages of a project. Bidders may attach little value to the probability of sales value (and success fees) at the top end of the scale. It may therefore be desirable to taper incentives, or to put a cap on the total level of success fees when considering large success fee payments. It should also be noted, that sliding scales may be doubly punitive in circumstances where failure occurs for factors beyond the control of advisors.

Balancing a retainer with a success fee
Generally the range of tasks that transaction advisors will need to undertake will comprise two groups. There will be those tasks that have a direct bearing on the outcome and those which need to be performed for the transaction to be completed, but will have little or no influence on the outcome. Where this occurs, it may be desirable to accompany the success fee with a retainer. The balance between the two will reflect the extent to which the range of tasks that the advisors undertake will impact on a successful outcome.

Recommendation 8.6: Success fees should give advisors an incentive to increase sales value or meet other government objectives. The appropriate structure will vary from case to case but should consider the achievable transaction goal, the relationship of the incentive to better sales performance, and the nature of any cap on the total fee.

8.3.4 And they can sometimes be used for sale of loss-making franchises
Where governments are selling assets, bidders will pay for the rights to the future profit stream associated with those assets. However, as discussed in other modules, governments may also be trying to increase private sector participation in loss making sectors. For a variety of reasons, governments may have a policy of particular services being run at a loss. The losses involved could be reduced if the rights to

operate the service and earn the revenues are competitively tendered. Examples include the competitive franchising of water services and of public transport.

In theory, the incentive for advisors can be structured in the same way. If effort by advisors can increase revenue from the sale of a profitable entity, it can also reduce losses from tendering out a loss making service. In the same way, that incentive could be based upon an improvement over the losses the government currently incurs, or over an informed estimate of the subsidy likely to be required if the franchise is tendered out. A key challenge of this approach is that loss-making services may often be characterized by cross-subsidies and hence it is will be difficult to estimate the overall level of subsidies for a sector at any point in time.

Recommendation 8.7: Success fees for the sale of loss-making franchises can provide similar incentives to improve the financial outcome for government.

8.3.5 Success may not just relate to the financial result

The most direct incentive is financial: whether to increase revenues or reduce losses. It is also possible to provide bonuses if specified outputs are delivered by a target date. Since transactions have clear milestones and it is often politically important to reach them by particular dates, advisors may be provided with incentives to stick to timetable. For example, transactions may need to be completed before an election. If timing is particularly important, this can be reflected in advisors' contracts. Bonuses can be offered for on time (or early) delivery of outputs on the critical path for the reform and transaction. However, in general advisors should be provided with sufficient incentive to deliver projects on time by the refusal of the government to pay their basic fees if the output is not produced, regardless of the payment structure.

8.4 Combination contracts

In addition to the main payment structures identified above, other forms of payment are possible which combine some or all of the above. For example, one combination might include a fixed fee to undertake those tasks that are easily definable, together with payments on a time and materials basis for additional tasks not specified in the initial TOR. As discussed, that is often the de facto result of many technical assistance contracts. Legal advisors may also have a mix of defined outputs, and an open-ended response to legal issues that arise late in the transaction.

8.5 Advisors can be retained on indefinite quantity contracts

Indefinite quantity contracts (also termed framework or drawdown contracts) refer to contracts in which an individual, company or consortium is hired for a specified, usually medium-term (e.g., 3-5 years), period to undertake tasks as and when the need arises. In other words, the specific workload is unknown at the outset, and all that is known is that advice is likely to be needed in a particular area.

In some cases government may be required to use Indefinite Quantity Contracts (IQCs) if they receive funds from certain donor agencies (most notably USAID, TACIS and PHARE). However, if governments are under no requirement to use IQCs, there may still be a case for considering their use anyway.

IQCs are usually signed because it is anticipated that this advice will have three particular characteristics:

- it will be required at short notice—making a lengthy competitive bidding process unacceptable;
- each individual piece of advice will be relatively small - making an expensive competitive bidding process inefficient - although added together the amount of advice is substantial;
- the general nature of all of the components of the assignment can be anticipated allowing a broad evaluation of the amount of advisory input that will be required.

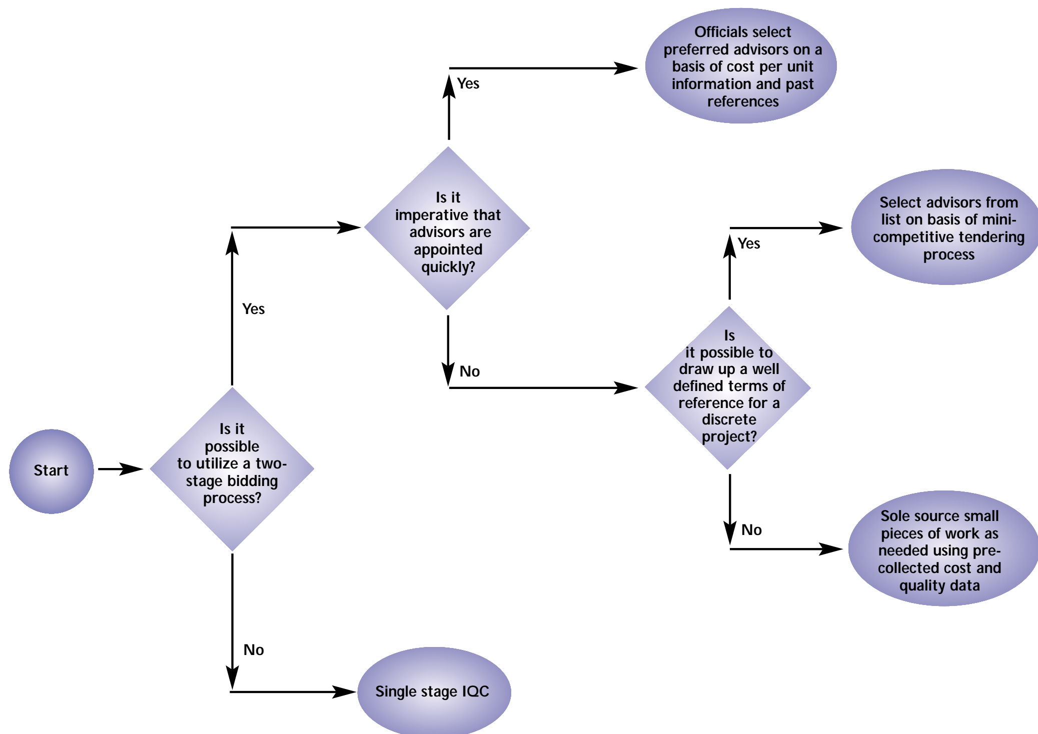
A combination of these three factors may mean that it is worth considering holding a competitive process to select a suitable advisor or set of advisors who can then be called upon when needed.

The process for deploying IQCs varies from agency to agency. A key factor which often differs across agencies is the extent to which different agencies use multiple rounds to determine which advisors are to be awarded contracts on this basis.

Some agencies (eg USAID) have multiple selection rounds before awarding IQCs. For example, at the start of a major reform, a government or agency may draw up a list of firms which will be invited to tender for specific projects over a period of time. The list itself will have been devised on the basis of a competitive tendering process, but also when the need for advisory services arises, firms on the shortlist may be asked to submit a brief proposal. If a multiple round process is to work effectively then the short list should be very small (preferably no more than three companies) otherwise the chance of winning enough projects to maintain interest is remote. Alternatively the shortlisting process should allow the government to invite a selection of advisory companies on the list to submit a proposal. Since the whole point of the indefinite quantity contract is to avoid having to go through the competitive tendering process each time a small job is required, the only way this process will work is if it is clear and transparent.

Others agencies have a more condensed single-round process where pieces of work are sole-sourced to one advisor (or advisory firm) that has been selected competitively at the start of a reform. This approach may be appropriate where advice is required at short notice, where the value of individual contracts is small or where the market for suitably qualified advisors is thin.

Figure 8-2
Different approaches to IQCs



Hence IQCs provide agencies with the flexibility to sole source or hold a quick competition as appropriate. However, by locking-in one set of advisors over a considerable period of time such contracts raise a number of issues that must be addressed.

The main issues are:

- How will companies be selected?
- Will individual companies or pre-formed consortia be selected?
- Will a short-list of companies be maintained or one company selected for each required speciality?
- Will a formal contract be signed with the advisory company(ies) for the entire period or for each project as they arise?

8.5.1 Selection for IQCs: firm and individual capability

As with any other bidding process, the selection of the advisory firm or consortium to undertake the contract can involve any of the combinations of technical and financial criteria as outlined in Module 7 (see Section 7.1.2). However, the long term, undefined nature of these contracts provide particular challenges. Most notably, since it is not known how often or for what precise tasks advisors will be called upon, they may not be able to submit assurances that specific individuals will be available, a work plan, a methodology or a fixed total price[12].

[12] Under some indefinite quantity contracts potential advisors will be able to present a methodology. For example, if a country is creating many regulatory offices (say, in each of many states) then an indefinite quantity contract may be signed so that as each state reforms the potential advisors are called in to set up the regulatory office. Under these conditions, it is possible for the companies to submit a detailed methodology covering how they would set up a regulator.

Consequently, evaluation must typically be based on the general capabilities of the companies in the area under question and the cost per advisor per hour of using their advice. However, the choice of consultancies based on unit price may result simply in the cheapest advisors being appointed—hence the desire for combining price and quality.

An important question that must be considered is whether the selection will be based solely on the company credentials or on those of individuals as well. In typical contracts, selection is weighted towards the individuals because they will be the ones actually undertaking the work. However, the uncertainties of indefinite quantity contracts (both in terms of the specific expertise required and whether specific individuals will be available in 2 or 3 years time) argues in favor of shifting the weighting towards company capabilities.

If naming individuals is favored (e.g., if there is a desire to ensure that a specific person with a particular skill is available) it is important to recognize that the long time period and unknown activation dates means that advisory firms may always be able to credibly claim that the requested individual is not available. Therefore, it is important to include in the contract clauses that allow the unit price to be adjusted according to the advisor who actually does the work and to ensure the work is to the quality that is expected of the person originally requested. Another method of trying to ensure that individuals named by the company in the original proposal remain active is to ensure that the company believes there is sufficient money available to make it worthwhile. If they anticipate that they can receive a substantial amount of money as long as the right people are available when called upon, there is greater incentive to provide those people.

Assessing the quality of companies and individuals in this field is difficult. When no specific job is being offered and the nature of the work is hard to anticipate in most cases there is no technical quality that can be assessed (at least in the first round of the bidding process for IQCs). Consequently, more general measures of capability must be evaluated, including:

- **Depth of experience** Both academic and practical – with greatest weight being placed on operations undertaken in the last few (say, 3-5) years. Over a long term contract it is unlikely that the same few individuals will be available. Consequently, this criterion should evaluate not just the individual CVs put forward, but also the depth of experience in the company to make sure it could perform even if these individuals are unavailable.

- **Breadth of experience** The range of sectors, countries and problems that the advisors have tackled is important since the advisors are likely to be called upon to look into a wide range of issues that touch upon their core speciality.

- **Success of activities** Has the company undertaken similar assignments in the past and were they successful? Past Perfomance References (PPRs) might be sought, although they ought to be treated with some caution. Successful past experience may be hard to verify and poor performance may not necessarily be the fault of the advisor.

8.5.2 Controlling costs

As identified above, the main problem with using price to establish the preferred company is that since there is no known output to be priced, the only measure available to use is the unit price - i.e. the hourly cost of individual advisors broken down by salary and overheads. However this information is of limited value because it is not clear how advisory firms will build a team when the time comes to undertake a specific project. Nor will the lowest priced advisors necessarily provide the best value for money. Consequently many agencies that use IQCs assign a lower weight to price proposals at the first round of the process for awarding IQCs than they do for fixed budget assignments or for when soliciting second round proposals for specific projects.

A further consideration arises because, over the length of such a long contract, prices will rise and people are unlikely to accept being paid the same amount per hour or per day at the beginning of the contract as they will at the end, which may be 5 years later. Three main options are available:

- **Use of multipliers** Agencies accept that annual salary increases will occur and establish constant multipliers, based on salaries, that will be applied for the period of the contract.

- **Internalization of price increases** Agencies accept that annual salary increases will occur but force the company to internalize these in their bids (i.e. they may bid their unit prices higher than their current rates but lower than they will be by the end of the contract so that over the entire contract they receive the appropriate average rate).

- **Benchmarking** Agencies allow an external benchmark to determine fee increases, i.e. use a widely published index. One benchmark that could be used would be announced increases in fee rates for a professional group (e.g., lawyers, management consultants) as an average over the top ten companies. An alternative might be the retail price index in the firm's home country. A further option might be comparison against the rates that are quoted in data bases of individual consultants. If this approach is adopted it is imperative that the index be a public publication which neither party can influence and both agree is readily identifiable[13].

Finally, it is important to recognize that over such a long period, staff may be promoted—increasing their fee rates. There are two main approaches that can be taken in this case:

- Accept the higher fee rate in order to continue working with the same individual; or
- Maintain the agreed fee rate and use a different individual—i.e. someone at the same level as the previous person prior to their promotion.

One approach to avoid problems with promotion is to agree a set of fee rates for different levels of people, rather than for specific individuals. In other words, agree that any Partner or Director will be paid US$X per day, any Manager US$Y per day and any consultant US$Z per day. The government can then request the mix of

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[13] In addition, a clause should be included in the contract informing both participants about the appropriate procedure should the index discontinue publication or change the definition of its coverage during the contract.

personnel it requires for each assignment and pay accordingly without worrying about specific individuals. The agency must only be careful that the firm is not promoting individuals or changing their titles simply to increase their rates.

8.5.3 Use of individual companies vs consortia

Another issue that must be addressed is whether the preliminary IQC bidding process should be based around individual companies bidding for specific work areas (e.g., legal, economic, technical, financial) or consortia that are able to deliver the whole range of skills.

There are two main advantages of asking advisory companies to propose individually for projects that might arise and require their specific skills:

- the government can select the best companies in each area rather than consortia that are likely to include a mixture of higher and lower quality companies; and
- the government avoids excluding strong individual companies which are unable to form relations with a consortium.

However, consortia also have important advantages:

- companies who have already established a protocol to collaborate as a consortium may be better able to coordinate the best approach to any given project; and
- the job of determining the appropriate group of advisors and managing that group is internalized within the consortium rather than being a job faced by the task manager in the government.

Under most conditions, the improved coordination among members of a consortium would suggest the latter approach. This option must be weighed against the individual contract's advantage of ensuring that each company has sufficient depth of experience to provide advice over the entire period. If individual company approach is adopted, a couple of further procedures should be considered:

- **Management** The ToR could include the management of the final consortium in the list of tasks. If a suitably qualified company is willing to take on this responsibility then that would remove the risk of co-ordinating the consortium from the government.

- **Communication** Where government retains overall management of advisory contracts for a range of firms, there should be a process for ensuring that the right skills are mobilized for the task in hand.

8.5.4 Different approaches to contracting

Within a single round process advisors can be signed with a variety of contractual approaches, including:

- a permanent retainer that pays them a specific amount every year;
- a time and material contract for each piece of work they undertake;
- through the submission of a brief proposal with an estimate of a lump sum contract; or
- a separate lump sum contract each time a new project arises, possibly using a quick competitive price/CV based process where several advisory companies are placed on a short list.

Since the exact extent and nature of the services to be provided under an IQC are not known at the commencement of the contract, the contract typically specifies a per person/per day unit price for each form of service that might be required over a fixed term. At the end of the term, the contract will expire.

Such contracts are effective in ensuring advice can be made available rapidly without the need for cumbersome procurement procedures. However, they also severely restrict the choice of advisors and may well lead to problems where the actual services required differ substantially from those envisaged when the contract was initially signed. In addition, they create a temptation for the government always to refer to its pre-signed advisors even when the issue that arises is outside their main set of expertise.

Recommendation 8.8: Indefinite quantity contracts should be used with caution, when it is known that upcoming assignments will be too small to merit competitive selection, when it is anticipated that the turnaround for individual assignments will be very quick, and when the projects are spread over a sufficient time period that they cannot be grouped into a single competitively bid contract.

8.6 The phasing of payments for advisors

In general, advisors will seek to be paid up front as far as possible, for cash flow reasons. They may also prefer upfront payment where there is a possibility that the government will default on a payment. On the other hand, it is in the interest of the government to link payments to outputs which must be delivered to requisite standards.

For large projects, lasting more than several months, it would be unreasonable to expect companies to undertake work for which they will not be paid for a long time. Government officials will therefore need to establish a payment or invoice schedule that sets out the points at which the company will receive payments. Where possible it would be desirable to align payments with the completion of specific outputs. Such outputs might not only include delivery of the final product, but also intermediate milestones such as reports, workshops and presentations (also see Module 4 of *Volume I*). It is usual practice that a portion of the payment (and often the largest share) to be reserved until the final output has been signed off.

Where phased payments are adopted, then officials will need to consider the payment profile. As a general rule, the payment schedule should reflect the amount of input that advisors will put into each stage of the work.

An example of a payment schedule is shown in Table 8-1 for a small project involving the training of new regulators.

Table 8-1
Payment schedule for $50,000 project involving training new regulators

Percentage	Amount ($)	Milestones
20%	10,000	Delivery of appropriate teaching material to the project officer
30%	15,000	Successful completion of the workshops
50%	25,000	Delivery of an acceptable report setting out consultants' recommendations for further training

For smaller projects, payments after completion of the work is usually sufficient for two reasons: smaller projects will be less likely to have multiple milestones, and the difficulties of cash flow are less likely to be an issue for shorter projects.

Recommendation 8.9: Governments should establish payment structures that broadly reflect the cost of expected inputs, make payment against defined outputs, and retain some leverage for final delivery.

8.7 Standard contractual safeguards will be needed for advisory contracts

As discussed in sections 8.1 to 8.4, the form of payment can be a method of allocating risks to different parties. Fixed price contracts tend to allocate cost-related risks to the contractor, whereas time and material contracts tend to place that risk on the government.

The inclusion of contractual safeguards provides an alternative way of protecting government interests and minimizing its liability. One approach is for the government to draw up a document setting out the general conditions of contract for services. A key issue in contract design is the appropriate allocation of risk across the different parties involved – primarily the government and their advisors, although under some circumstances the government will need to consider the contractual relationship between its lead advisors and advisors' sub-contractors. Where sub-contractors are being used, it is usually the responsibility of the lead contractor to agree a contract with its sub-contractor. However, the main contract may need to ensure that the government is protected against the actions of sub-contractors to prevent, for example, the disclosure of confidential information or conflicts of interest.

The contract that the government draws up is likely to address some or all of the following issues:

- **Confidentiality** Disclosure of confidential information and retention of documentation. Advisors working on confidential issues may be required to adhere to government rules relating to the disclosure of confidential information and to return all copies of confidential information that is provided to them during the course of their work.

- **Receipt of gifts or payment of commission** Advisors will need to be made aware of procedures for informing the government of receipt of gifts or commission.

- **Merger, takeover or change of control** This would require the advisor to inform the government of any potential changes of ownership. This is important because any changes in ownership can be a potential source of conflict of interest.

- **Termination of contract** The conditions under which the contract can be terminated without notice. Possible grounds for termination include breach of confidentiality agreements by advisors, failure of advisors to meet requisite standards of performance, if the advisors cease to carry on their business or if there is a change of ownership of control.

- **The use of sub-contractors or change of personnel** The advisor might be required to inform the government if new sub-contractors are appointed or individuals other than those named in the team undertake the tasks included in the contract. This is important if substitution of personnel gives rise to conflicts of interest and may be grounds for termination of the contract.

- **Insurance** The contractor's responsibility to take out professional indemnity insurance and under which country's law's it should apply. This is usually the country of the contracting government, although it may differ if the funding sources are grant-giving institutions.

- **Insolvency of the contractor** The conditions under which the contractor needs to inform the government of bankruptcy or insolvency.

- **Arbitration** The process that will be undertaken in the event of a dispute.

- **Exchange rate fluctuations** The contract will normally state the currency that the payments are to be made in and the arrangements for reimbursing expenditures arising in foreign currencies.

- **Payment of local taxes** The contract will need to specify which local taxes will need to be paid and whether the sums invoiced will include taxes.

While the contract between the government and its advisors provides the government with a degree of security, it should only be relied upon as a safeguard of the last resort. Ideally, if problems with advisors occur, these should be discussed openly and settled during the course of the project. Furthermore, even though the contract provides legal protection, in the event of any dispute, it should be born in mind that court settlements can be time consuming and expensive.

Useful reading

HM Treasury, *How to Appoint and Manage Advisers*, Technical Note #3, UK Government, 1999.

McAfee, P., *Incentives in Government Contracting*, University of Toronto Press, 1988.

Stockdale, A., *The politics of privatisation in Victoria* in **Privatisation International**, November 1999