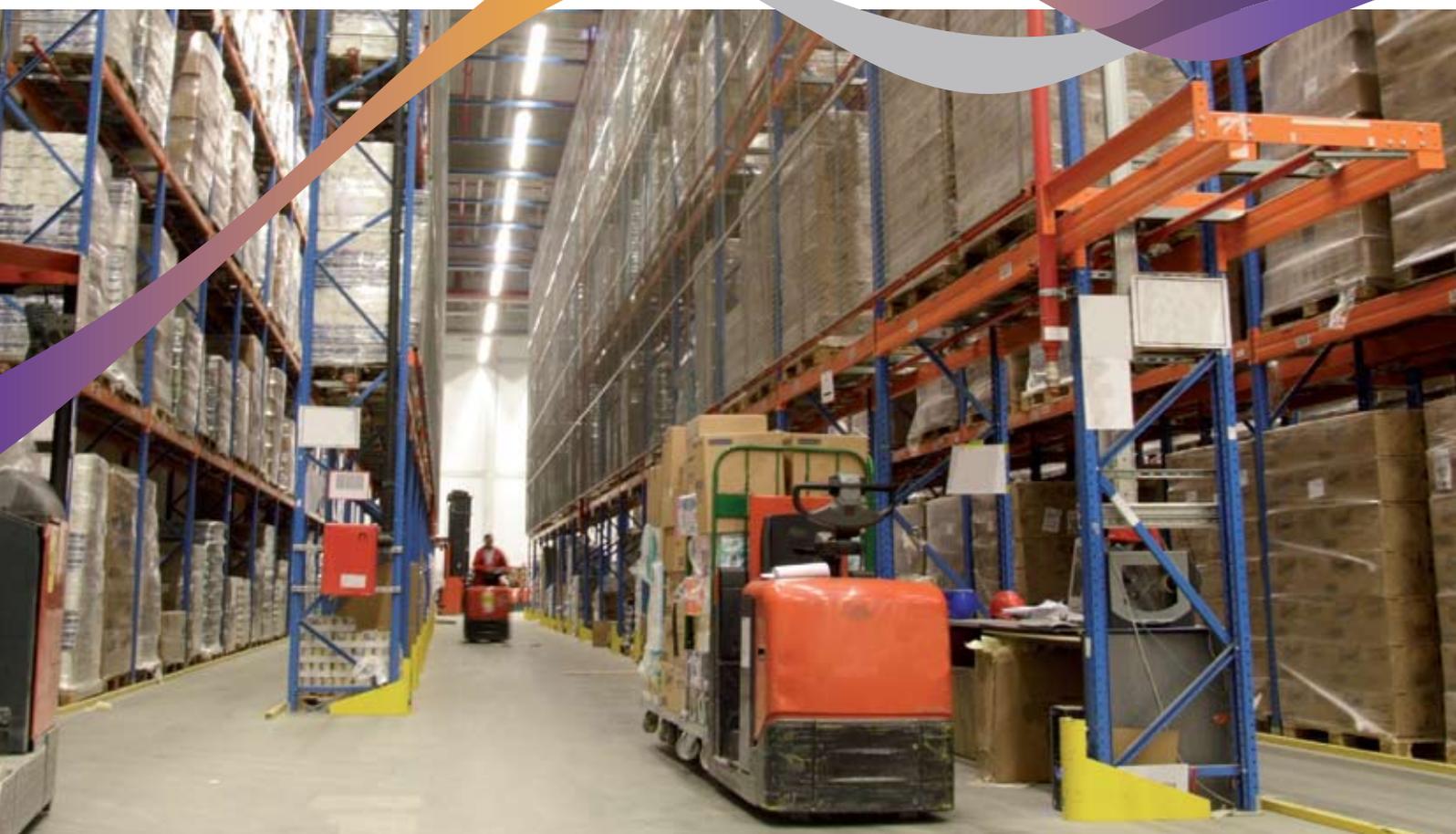


IMPROVEMENT OF PUBLIC PROCUREMENT PROCEDURES

Recommendations and materials prepared
by the Industrial Companies Working Group



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IMPROVEMENT OF PUBLIC PROCUREMENT PROCEDURE

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UDC 351.712

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“Improvement of Public Procurement Procedure. Recommendations and materials prepared by the Industrial Companies Working Group” summarizes the outcome of joint work of 17 companies: representatives of Moscow Government, international and Russian companies and not-for-profit organizations. The Industrial Companies Working Group (ICWG) is a unique initiative organized by the International Business Leaders Forum (IBLF) which pools the efforts of commercial, governmental and not-for-profit organizations to improve the process of public procurement. During the three months, from March to May 2012, ICWG completed the analyses of Federal Law “On Federal Contract System in the Sector of Goods, Works and Services Procurement” and provided recommendations on its improvement to the authors at the Ministry of Economic Development of the Russian Federation. Through joint efforts, the members of ICWG have studied existing public procurement procedures exercised in Moscow and outlined the directions of their improvement, They studied corporate practice in internal procurement and described mechanisms and procedures that allow commercial companies to minimize the risk of unfair behaviour and corruption at all stages of the procurement process. Based on the results of the study of public and corporate procurement, ICWG developed recommendations on improvement of the public procurement process.

The publication includes all conclusions and recommendations worked out by ICWG, as well as attitudes of several ICWG members. The main goal of the publication is to bring to general public attention the business community perception of public procurement in Russia, to raise the problems revealed during ICWG work and to suggest solutions for development of civilized and transparent competitive environment in Russia.

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OPENING ADDRESS

IMPORTANCE OF IMPROVING PUBLIC PROCUREMENT PROCESS

It is quite obvious that the problem of the public procurement system inefficiency is not only specific to Russia, but is common in many other countries as well. The corruption component is not the only reason behind this problem which is also caused by the imperfect procedures of the public purchases and the gaps in the legislative base regulating the whole process.

Certain problems arise in the course of interaction between the public authorities and their counteragents because the sector of state purchasing can be home to organizations which are far from being concerned with proper fulfilment of the public contracts they have been awarded.

Nowadays we are witnessing serious reinvention of the whole public procurement system and moving towards a contractual system. The work is underway on the federal level in alliance with the regions, business community and society.

The Moscow Government is paying serious attention to this issue taking into consideration



A.V. Sharonov, Vice-Mayor of Moscow for Economic Policy, Moscow Government

that the market for public procurement in the capital city is enormous – over 600 billion rubles (US\$20 billion) per year.

To improve its procurement system, the Moscow Government, in cooperation with the International Business Leaders Forum, has started work along the following guidelines:

1. Preparation of recommendations aimed at the improvement of the public procurement process, including regulatory documents and standard public contracts.
2. Initiating measures to reduce corruption risks.
3. Engaging representatives of IBLF as experts capable of evaluating the validity and transparency of technical specifications in big government purchases.
4. Direct involvement of foreign producers in tenders and auctions.
5. Drawing up proposals for adaptation in Moscow of the best procurement practices existing both in the corporate sector and in the leading European capital cities.

Thus, mechanisms and innovations that would result from our common efforts could be used not only in Moscow but in other Russian regions as well.

INTERSECTORAL PARTNERSHIP AND COOPERATION AS A WAY TO IMPROVE EFFICIENCY IN THE FIELD OF PUBLIC PROCUREMENT

Public procurement is a vital process that both reflects and secures the quality of relations between the government, society and business.

The government agencies engaged in procurement represent the interests of the society and must allocate budget funds with utmost efficiency in order to deliver high living standards for the public. The public, being the main consumer or the end user of the services and goods procured by the government, is interested in obtaining quality products, high standard services and comfortable living conditions. The business, producing goods and services, is certainly motivated to sell them to the government and the public as the end users. That is an ultimate ideal situation. In Russia, however, the actual relations in the sphere of public procurement are in need of serious improvement. Today major producers are often reluctant to directly participate in public procurement, resorting to services of intermediary companies. In this way business reduces its reputational and financial risks inherent in the uncivilized competition environment with its lack of transparency, clear-cut rules and procedures comfortable for the business.

Intermediaries tend to boost the price of goods and services and are often incapable of securing their proper quality and delivery rate. It is not surprising, therefore, that the government bodies are dissatisfied with the inefficient spending which is disproportionate to the outcome. As a result, the affected party is the ultimate customer who suffers from low quality of life.

The need to improve the public procurement system is brewing, all stakeholders – government, business and general public – are aware of this need and the process of changes has already been launched. The draft law On Federal Purchasing System in Procurement of Goods, Work and Services is actively discussed and improved.

Nevertheless, achieving a comprehensive solution to this complicated problem requires more than political will. A systematic approach capable of taking into account all factors affecting the public procurement process is needed. Such an approach can be realized through intersectoral part-

nership which would ensure purposeful collective efforts of various stakeholders. In fact, such a partnership has been formed within the framework of the Industrial Companies Working Group – the initiative of the International Business Leaders Forum implemented together with the Moscow Government.

The partnership experience described in the proposed publication was presented by the author and highly appreciated at two events of the Rio+20 UN Conference on sustainable development in June 2012 – “business reputation” “The Future We Want”: first at the Section on Sustainable and Comprehensive Development: “From Organizational Changes to Collective Actions” of the Rio+20 Corporate Sustainability Forum. Then it was presented at the 10th meeting of the Working Group of the anti-corruption UN Global Compact.

I hope that through our coordinated actions we will be able to enhance the efficiency of public procurement processes in Moscow and will include this practical experience to the federal legislation to be used in all regions of Russia.



Boris N. Tkachenko,
Head of the Branch Office IBLF in Russia

EXPERT ASSESSMENT OF INTERNATIONAL PUBLIC PROCUREMENT PROCEDURES

THE POWER OF PROCUREMENT IN LOCAL GOVERNMENT

Around the world public sector organisations are experiencing an unprecedented pace of change. As a result, they are rapidly re-evaluating their operating models and market strategies not just to withstand these market forces, but capitalise on them.

Clearly, Procurement has a significant role to play in helping the public sector achieve their objectives and prepare for the uncertainty ahead. In part, this will require Procurement to focus on driving costs out of the cost base. But the opportunity also exists for the function to add value in a much more strategic way.

And as we engage with Procurement functions around the world, KPMG firms' professionals have witnessed a number of highly mature Pro-



Claire Pearson, Principal Advisor Public Sector Management Consulting, KPMG (UK)

urement organisations that have stepped-up their game, fundamentally changing the way they work with their internal stakeholders and – as a result – increasingly taking a leadership role in helping drive growth and reduce costs across the organisation. But what exactly does a 'mature' Procurement function look like in the public sector and more specifically local government? How are they adding value beyond traditional cost-cutting measures? And what can less mature organisations learn from their more evolved peers?

In order to better quantify the maturity of Procurement functions around the world KPMG, in association with CPO Agenda, surveyed 585 Procurement leaders across the world. What we found was that – overall – there is a significant gap between where Procurement is now and where they could be. We believe that it is useful to apply experience from across the public and private sectors to public sector organisations, in order to prompt the most dramatic improvements in public sector capabilities.

In particular, our research identified five key areas where Procurement could be elevating its game to add significant value to its organisation:

- **Partnering with the organisation.** For Procurement to achieve a place at the table, more work should be done to align to key stakeholders and understand the business operations to become a true strategic partner. This means moving up the value chain to ensure that the function is involved much earlier in the decision-making processes and clearly demonstrating how active involvement adds tangible value to both the bottom and the top lines.
- **Moving beyond cost savings.** Driving costs from supply contracts will always be a central tenet of Procurement, but many organisations, particularly in local government and public sector health provision seem to be struggling to focus on cost over risk and to extend their

activities proactively into core capabilities such as category management, and beyond into demand management and Supplier Relationship Management (SRM). In the EU as a result of the Public Procurement Directive, local government procurement departments there is a tendency to focus more on risk management and compliance with the regulations than cost; instead of ensuring regulations are complied with and achieving the best deal. With relatively low levels of spend under contract and under management in many sectors, there remains a significant opportunity for Procurement to stretch beyond cost savings to deliver more strategic value to the organisation.

- **Achieving the optimal operating model.** Whilst the majority of Procurement organisations have already adopted a more centralised operating model, many still face challenges in translating this into strategic value for their businesses and in the local government sector, a centralised team is often excluded from commercially influencing the spend associated with front-line services. CPOs and Supply Chain Directors will increasingly find themselves reassessing their operating models to squeeze greater value from their activities around the world, while providing a robust centralised framework that delivers efficiencies across the business at a reduced operating cost for the function as a whole.
- **Prioritising supply chain risk.** Given the events of the past five years – financial crisis, natural disasters and massive supplier failures, to name just a few – the research demonstrates a worrying lack of leadership in the area of supplier risk. Procurement will need aggressively to push the inclusion of supply chain risk on the broader business agenda in order to protect the business from the uncertainty and turbulence that almost certainly lies ahead. This is of particular relevance to local government and large metropolitan areas because members often seek to boost local business by blanket-mandating that council spend is directed towards small local suppliers regardless of the point in the supply chain where value is added. It makes little sense to mandate that a small local stationery provider

is used, when the product are manufactured across the world. It may make more sense to focus on local services that are labour intensive and where the real value is provided at the end of the supply chain, for example helping elderly people to remain in their own homes through the provision of home based care.

- **Leveraging systems and technology.** Whilst supply chain technology and business systems have evolved rapidly, many Procurement functions seem unable – possibly unwilling – to leverage these new capabilities in order to bring greater automation to the business. In many cases, the situation is even more alarming: having made the investments, they have yet to realise the value. In particular, the business will increasingly be looking to Procurement to maximise their existing systems and technology to provide greater clarity into the Management Information and Business Intelligence processes.

Based on this research, it is clear that there is ample opportunity for most Procurement functions to drive additional value into their organisations. But this means changing the status quo and actively working to enhance the value, capabilities and reputation of the Procurement function throughout the business.

In part, this will require CPOs and Supply Chain Directors to clearly articulate the tangible benefits of embedding Procurement into the business planning and decision-making processes. But it also means getting the basics right: bringing spend under contract, auditing and monitoring progress, reducing costs and making better use of systems and technology.

The results could be amazing. Councils with mature Procurement functions enjoy lower cost growth, greater business flexibility and responsiveness to changing political mandates, increased market development capability and – as a result – significant competitive advantage over their peers. Mature procurement capability enables councils to more easily manage transparent commercial dealings and mature councils might ultimately be able to offer some of their back office and middle office services to peers as a traded capability. Those that fail to mature will find themselves relegated to simply reviewing and

negotiating contracts, forever to remain as tactical 'order takers' rather than the strategic leaders that they could – and should – aspire to be.

Now it is up to the CPOs and Supply Chain Directors to change the status quo and claim their rightful place at the table. We've looked at some of the features that world-leading councils will need to display in the coming decade and summarised the key points here.

Key Features of forward-thinking councils

In order for forward-thinking city/regional councils to adapt to a more transparent and accountable citizenship, the following features could play an important part:

- have highly skilled political leaders, high calibre councillors and a cabinet focused on outcomes (not just outputs)¹ and financial control;
- have a truly accountable Head of Paid service (the Chief Executive or equivalent) and executive team;
- frame a commercial business plan for the council and deploy a new operating model to deliver it;
- reduce the behavioural autonomy of directorate silos within the overall business of the council;
- deploy an iron-like grip on the finances of the council with a board of shareholders mentality (local citizens being the shareholders seeking maximum returns);
- markedly increase the productivity and performance of its staff and suppliers;
- focus ruthlessly on outcomes for its citizenship and communities and be agnostic about which part of the economy delivers service provision;
- implement payment by results for anything it funds in its supply chain;
- enthusiastically cede control to others, including to local communities, as a critical tactic to secure better results for customers and citizens.

Necessary Action

In order to optimise the results achieved, we typically find that councils will need to undertake the following actions:

- implement new local political governance arrangements that influence the nature of all local public service delivery;
- ensure much higher quality customer services, accountable to local people in performance terms, the real costs of which are transparent and understood;
- achieve greater prosperity and wellbeing for local people by brokering better social, economic and environmental outcomes;
- drastically reduce costs through innovative and collaborative partnerships that make the best use of technology;
- be more passionate about delivering the best possible outcomes for local people and more agnostic about who delivers services;
- be clearer about their core purpose and withdraw more completely from activities that do not directly support this;
- achieve major change in their ethos and activities primarily in order to foster a "one-council" approach, and operate at pace.

A Political Organisation

Local Government is by definition political. Politically in future, council's will be about:

- articulating the voice of local citizens and representing and promoting the aspirations and needs of local communities;
- democratic accountability and legitimacy for decisions;
- allocating and rationing resources;
- brokering public services to achieve quality outcomes on behalf of residents; to protect them; to offer opportunity; and to ensure quality of life for all citizens;

¹ Traditionally, councils specify the inputs of a service either to be self-provided or provided by suppliers. This needs to change not just from Inputs (provide foster care for a young person and keep them safe) to Outputs (the young people that you provide foster care for will go to school regularly) but to Outcomes (the young person will be able to maintain a stable foster placement and improve their educational achievements as a result of the foster care setting you provide for them).

- place shaping – setting the vision for the locality and co-ordinating/ influencing public, private and third sector stakeholders to maximise community wellbeing;
- ensuring that communities are encouraged to help play their part in developing and maintaining their locality.

Procurement activity in local government must be designed to achieve the objectives their politicians set within the above framework.

Summary

In future, councils will need to use their business plan and operating model to really understand the underlying cost base, cash flows and cost drivers of its non-pay spend, and exercise strict financial grip over its operations. They will need to focus relentlessly on the core business of the organisation, taking the opportunity to stop doing or securing alternative sources of provision for non-core activities. Procurement outcomes will need to reflect the actual needs, demands and choices of local people.



PUBLIC PROCUREMENT PROCEDURES IN RUSSIA

PUBLIC PROCUREMENT PRACTICES IN MOSCOW: MAIN CHALLENGES AND OPPORTUNITIES FOR IMPROVEMENT



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Nowadays the problems of public procurement are under severe scrutiny of the government, mass media and, due to Russia's accession to the WTO, the foreign business community. Among the negative factors discussed are the following: undue complexity and overregulation of the legislative framework focus on price in choosing the winner, lack of comprehensive control over all procurement stages, existing corruption risks and facts of unscrupulous behaviour of both customers and counteragents.

There are four sources of risks existing in the sphere of public procurement:

- **customers** – unsatisfactory planning, tailoring documents to the needs of specific suppliers, unreasonable requirements regarding the procured goods (services), ill-founded initial pricing, restriction of access to open information, low contractual discipline;
- **committees** – unreasonable behaviour in evaluation and selection of winners;
- **electronic tender platform** – technical failures, disclosure of information about bidders, blocking access of participants;
- **suppliers** (contractors, providers) – submitting unreliable information and documents, unfair competition, collusion (both with other bidders and with customers), substandard contract performance, etc.

Risk of various combinations of collusion between the participants of the procurement process should also be mentioned.

In order to minimize all those risks, serious efforts are currently being made to streamline the legislation on the Federal Purchasing System (by the Economic Development Ministry and Federal Antimonopoly Ser-

vice). The respective draft law was brought in to the State Duma on May 7, 2012. However, it still lacks certain mechanisms to provide for complete eradication of the existing problems, among them the necessity:

1. to raise the efficiency of providing information about the needs (published schedules often give rather vague information on what exactly has to be done or supplied).
2. to create a transparent system of pricing and an efficient system to monitor the process of establishing initial prices.
3. to avoid going into excessive details of requirements specifications.
4. to minimize the cases of sole source tenders.
5. to seek for direct involvement of producers (including foreign ones) in tenders.
6. to introduce the criterion “business reputation” in the sphere of public procurement (instead of the current “qualification”).

The Tender Committee together with IBLF has prepared proposals designed to amend the draft law. Within the framework of the powers vested in the Russian Federation subject, Moscow authorities are working on perfecting the mechanisms of procurement.

Thus, to improve the efficiency of placement of orders for supply of goods, work and services for the public needs of Moscow city and for the needs of its budget-funded organizations, a number of regulatory orders concerning placement of the state order were adopted by the Moscow Government in February 2012. In particular, on 24 February, 2012, the Moscow Government decree No. 67-ПП On Procurement System in Moscow was passed, which stipulates the fundamental rules of planning and placement of orders, the requirements to the contract performance and the procedures of dispute resolution and claims.

To establish additional control, the said decree envisages compulsory interdepartmental approval of big purchases:

1. purchases at the initial (maximum) price of over 1 billion rubles shall be approved by the Mayor of Moscow (involving the Department for Economic Policy and Development of Moscow, Tender Committee, Main Oversight Directorate

and Moscow Office of the Federal Antimonopoly Service).

2. purchases from 100 million to 1 billion rubles shall be approved by the Interdepartmental Working Group (involving the Department for Economic Policy and Development of Moscow, Tender Committee, Main Oversight Directorate and Moscow Office of the Federal Antimonopoly Service).
3. purchases from 3 million to 100 million rubles shall be approved by the working group of the budget controller responsible for the review of the validity of the needs declared.

In addition to the above-mentioned decree, the Moscow Government adopted decree No. 68-ПП of 27 February 2012 On Procedure of Formation Initial (Maximum) Price of Public Contracts and Civil Law Contracts in Placing Orders for Supply of Goods, Work and Services Funded by the Moscow Budget.

While providing methods of calculating the initial (maximum) price of the contract, the document stipulates the obligation to obtain an expert opinion of an independent expert organization on the validity of determination of the initial (maximum) price of the contract (lot price) in cases when such calculated price is equal to or exceeds 50 million rubles.

The efficiency of the measures taken by the Moscow Government is confirmed by the positive dynamics of procurement processes. During the first five months of 2012 Moscow customers held tenders totaling **255 billion** rubles (for the funds allocated by the budget). That accounts for **70%** of the planned annual expenditures and is nearly twice as much as that in the first six months of the previous year. All indicators characterizing the competitiveness of the purchases have a **positive trend**:

- the average quantity of the bids: 4.8 (3.4 in 2011);
- the average quantity of the accepted bidders: 2.7 (2.3);
- the share of “sole source tenders”: 22.6% (31.2%).

Moscow city customers are provided with the following indicators for the end of 2012:

Indicators	Acceptable level	Target level	Optimistic level
Average quantity of accepted bidders	3	4	5
Share of sole source tenders	20	15	10

The majority of orders are now placed by means of electronic auctions, which leads to a greater role of the operators running the respective electronic platforms. The Department for Competition Policy together with the electronic trading platforms have examined and approved approaches to the evaluation of the e-platforms performance with regard to the efficiency and competitiveness of all the procedures organized by Moscow customers.

The Tender Committee is planning to introduce a system of ranking the electronic trading platforms envisaging the possibility to transfer a certain number of purchases to the “best” platforms capable of ensuring greater efficiency and refuse from cooperation with the “worst” platforms.

It should be noted that an efficient and well-planned system of public procurement is the most important factor of sustainable growth in this country. A significant role is played by purchases of state-owned companies whose activities are regulated by the provisions of Federal Law No. 223-FZ On Purchases

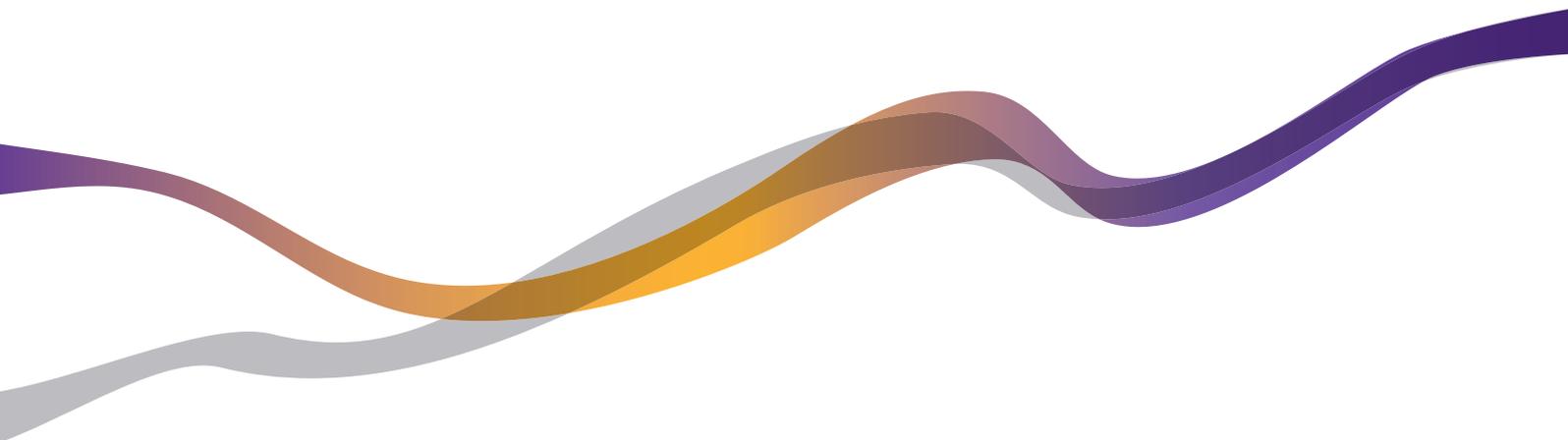
of Goods, Work and Services by Individual Types of Legal Entities.

Following up the implementation of Law No. 223-FZ, a selective monitoring was carried out to check the compliance with the requirements of the law, which revealed unsatisfactory performance of the legal entities governed by this law. As a result, the Tender Committee and the Moscow City Property Department are planning to provide the methodology of procurement processes used by state-owned companies, notably, to develop and introduce standard documents to be used in purchases contracted under Law No.223 and to form a procurement reporting system.

Apart from that, in order to solve the existing problems, the Moscow City Department for Competition Policy is collaborating with the business community, IBLF and the Industrial Companies Working Group along the following lines:

- examination and analysis of procurement practices of big corporations with the view of identifying the anti-corruption mechanisms and schemes used by business;
- examination of the public procurement procedures and methods used in Moscow in order to find out the weak spots allowing for unfair behaviour of both parties.

The efforts aimed at improving the efficiency and transparency of public procurement in Moscow are going to be continued.



REAL COMPETITION IS ADVANTAGEOUS FOR ALL

Everytime there is a lack of competition, no matter where, when and for what reason, one will face two immediate results:

- no incentive to invest into R&D;
- no natural need for innovations and production optimization (including cost effectiveness).

Companies, public sector, and ultimately consumers – all need to understand it. On the other end, there are clear benefits of fair competition for manufacturers/service providers and consumers.

For consumers:

- Cheaper prices
- Higher quality of goods and services
- Better choice of goods and services
- More innovative technologies

For manufacturers and service providers:

- Fair remuneration/profit
- A market access for new players
- An motive to invest into R&D and innovations.

The two largest and most recognized systems of competition regulation are United States antitrust law and European Union competition law. National and regional competition authorities across the world have united into international alliances and enforcement networks. The principles of fair competition in Russia as elsewhere in the world are also protected by law. And as such, classical competition law, or antitrust law, has three main elements:

- prohibiting agreements or practices that restrict free trading and competition between business. This includes in particular the repression of free trade caused by cartels;
- banning abusive behavior by a firm dominating a market, or anti-competitive practices that tend to lead to such a dominant position;
- supervising the mergers and acquisitions of large corporations, including some joint ventures. Transactions that are considered to threaten the competitive process can be prohibited altogether.

However the forms of competition vary for different industries and are subject to specifics. The meaning of unfair advantage in business competition may be vague, especially if different competitors promote different interpretations which suit their own interests. It may get hard to define what

it means to compete on equal terms, and the operative terms of competition that exist in reality may be challenged only when a participant is seriously disadvantaged by them. Often “equal terms” is defined as an “equal opportunity” or “equal chance” to compete.

Value for money is not only related to price but includes quality, cost of ownership, and uptime

There is a lack of a holistic approach to costs and benefits in Russia. Often decisions regarding capital expenditure are not based on a total cost of ownership approach, but on a cost of initial investment approach. The Federal Law 94 on public procurement does not address these issues, however to be fair we need to admit – it is by itself a giant leap in public procurement.

This case is very clear in lighting. The initial expenditure for energy-efficient, smart, high-quality lighting in our streets, offices and houses



Arjan de Jongste, general director Philips Russia and CIS

tends to be higher than the expenditure on traditional, electricity-guzzling lighting systems. Thus too often, in a seemingly price-competitive environment, wrong decisions may be taken on a nation-wide scale.

Given the size of the territory, the manufacturing might and number of households in Russia that need to be lit, one can imagine the economic harm of ineffective competition regulations applied in public procurement. This is also related to year-on-year budgetary planning traditions at federal, regional and municipal levels. In many instances, decision-makers are accountable for driving energy efficient economics savings within one year and not in a longer-term perspective.

Whereas the total cost of ownership over the whole lifecycle (initial capital expenditure plus electricity consumption plus maintenance) is much higher for the traditional solution, the initial expenditure is lower. However not all know that it is financially much wiser to buy a 5 euro energy efficient light bulb than to buy its 1 euro incandescent counterpart. Over the lifetime of the energy efficient bulb, the savings in electricity consumption and replacement outweigh the higher initial cost in Russia and far do so in Europe due to higher electricity tariffs. Thus, many people buy incandescent bulbs and the same holds true at the professional and institutional level.

Innovation is only valued properly when explained in its application context which requires expertise to understand and appreciate

Our societies face major environmental, social and financial challenges. We consume too much energy and produce too many pollutants in the process. Healthcare quality is under pressure, while its costs threaten to spiral out of control. In many developed countries, the economic climate is difficult and public deficits have reached dangerous limits. How can innovation help us to overcome these challenges in a difficult financial context and at what cost? Will they be able to compete and

look competitive to those who take decisions in the domain of both consumer and professional/public procurement?

Imagine the world saved an annual 128 billion euros on electricity consumption, reducing carbon dioxide output by a staggering 670 million metric tons in the process.

Imagine the German healthcare system alone saved 500 million euros a year on the treatment of acute chest pain, while improving care at the same time.

Imagine the US saved 8 billion dollar annually by reducing avoidable hospital readmissions of people with a chronic cardiovascular condition, allowing patients to stay safely in the trusted setting of their homes.

Imagine Russia saved 13% of all deaths including due to earlier cancer diagnostics.

The cost and CO₂ savings in electricity consumption would result from a simple worldwide switch to energy efficient lighting, to products and solutions that are already available in the market, here and now. About 19% of the electricity generated globally is used for lighting purposes and around 70% of all existing lighting equipment is clearly energy inefficient by today's standards. Existing state-of-the-art technologies, including LEDs, can provide energy savings of up to 40%. In a few years, this saving potential is expected to increase to more than 90% for individual projects!

To make this more tangible: these savings are equivalent to switching off 642 power plants or at least half of all the nuclear capacity installed worldwide! At the same time, the quality of these intelligent lighting solutions helps people to feel better and be more productive, and to increase the feeling of safety in our cities and streets.

The importance of improving the care for chronic patients while reducing its costs can hardly be overemphasized. As our societies are aging, by the year 2050 an estimated 50% of all people in the developed world will suffer some form of chronic disease – cardiovascular, cancer, diabetes, pulmonary conditions. At the same time, chronic diseases have also become the most important cause of death in most emerging and developing countries, including Russia, China and India. It is clear we need creative, innovative solutions to avoid healthcare costs spiraling out of control.

In addition, the scarcity of well-trained healthcare professionals – nurses, doctors, maintenance personnel – is a huge concern in all emerging markets and may seriously hamper their future development. In India, the gap between demand and supply of doctors is already 50%. In China, 20,000 experienced physiotherapists have the burden to serve 2 million new stroke patients every year. In many emerging markets, the shortage is exacerbated by the emigration of qualified nurses to developed countries. In Russia, a country with one of the highest ratio of doctors to population, there is an extreme scarcity of junior medical personnel, including nurses and clinical assistants and a shortage of qualified doctors in remote and rural areas.

The idea that new technologies would make healthcare more expensive is a misconception. In fact, the cost of purchasing medical equipment is less than 2% of the total healthcare budget. Personnel costs are by far the biggest cost item in healthcare – over 70%! – and it is innovation that can help to limit these costs, and to reduce the growing shortage of personnel whilst at the same time improve the quality of healthcare.

Right product for the right application

The financial investments needed to achieve these improvements in our healthcare and energy systems are modest compared to the resulting savings. The return on investment is very high; the pay-back time very short. From a soci-

etal point of view, therefore, these investments are no-brainers. We can save costs; we can reduce pollution and energy dependency; we can improve our healthcare. Moreover, as we are increasingly worried about high public deficits, we can reduce these deficits by investments that lower cities' electricity bills as well as running costs in public healthcare systems, since these investments are literally self-financing and provide significantly lower total costs of ownership.

A city that runs up an annual electricity bill of 50 million euros – mainly because of street lighting – could easily reduce that bill to less than 20 million euros and improve the quality of street lighting at the same time by switching to modern, energy efficient and smart solutions. What's more, new lighting systems reduce the need for currently very scarce maintenance personnel with a factor 5 to 10.

And all this holds true even without taking into account additional benefits. In the case of lighting, these include lower costs for air conditioning, as LED-based lighting produces much less heat; savings in high voltage grid capacity; and lower maintenance costs for lighting systems – state-of-the-art light sources have a hassle-free lifetime of more than twenty years, as opposed to three years for many of those currently installed.

In healthcare, increasing the efficacy and speed of treatment has a positive effect well beyond the reduction in direct healthcare costs. The negative economic impact of chronic diseases – mainly loss of productivity – is estimated at four times (!) the direct healthcare costs.

So if investing in these innovative solutions is a no-brainer, why don't we do more of it? Why don't we invest ourselves out of the crisis? Why are we on a very slow evolutionary track, whereas a revolution is called for if we are to tackle the big environmental, social and financial challenges we are facing? What are the roadblocks that hold us back and how can we overcome them? Which solutions can show us the way to go?

The challenge ahead is to create an institutional environment in Russia to promote these clear ideas

and reasoning. The holistic approach to do public procurement is about having a competitive and thoughtful enough legislative ecosystem which fosters innovations. Thanks to its huge purchasing

power, the government is capable of really boosting demand for innovative products and services. The success of a lot of innovation depends wholly on the existence of an important 'launching customer.'



PUBLIC PROCUREMENT IN HEALTHCARE SECTOR: BUSINESS' OPINION

Johnson & Johnson has been selling goods for professional health services in Russia since 1991. The Russian healthcare system is structured in such a way that the principal purchaser of medical devices and equipment has always been the state. Business in the public health sector is carried out as b2g, with four-fifths of the total funding being provided through the state budget.

Of all industries based on the interrelationship between private and public sectors the role of the government is especially significant in healthcare industry. Its regulatory function is steadily growing both in Russia and in the countries with strong involvement of private players in the medical services. This is undoubtedly a positive trend, bearing in mind that a well performing healthcare system contributes a great deal to the general economic development of the country.

In recent years, the escalation of bureaucracy in the Russian healthcare system has been noticeable in the processes of the public procurement ("goszakaz") as well. Market regulators are striving to enhance the efficiency of budget expenditure by state hospitals and promote competition in the public procurement market. Doctors in their everyday work in state hospitals perform another, probably even more central, role of the state – securing the right of the citizens to obtain proper health care and medical assistance (Article 41 of the RF Constitution). They are the very "internal customers" of any state hospital engaged in purchasing medical devices and equipment with the use of the budget funds.

The healthcare system in any hospital should be aimed at providing safe and effective medical services and protecting the patients' rights, which constitutes the basis for procurement decisions made by the administration and controllers with obligatory consideration of the opinion of their doctors.

It is fair to say that the task of any doctor is to provide treatment rather than engage in purchasing. At the same time, lack of the materials and equipment required for proper treatment makes doctors feel frustrated and fearing to be accused of

professional negligence. This may become the reason why doctors resign from state hospitals or even leave their profession altogether.

The doctor who articulates the need in a medical device is forced to grapple with the complexities of legislative regulations and numerous, often full of contradictions, law enforcement practices which are handled by non-clinic professionals of state hospital, such as lawyers, procurement officers or accountants. As a result, the doctor striving to manage the disease and the non-clinic professional trying to comply with multiple constraints in the process of procurement cease to cooperate effectively.

The outcome of such contradiction can be illustrated by a simple example: the neurosurgery department of any state hospital uses suture materials for suturing brain vessels. The surgeon, intending to decrease the risk of surgical site infection that could develop in surgery, would order an antibacterial suture material. Among the numerous substances used to manufacture suture material there are substances which are counterindicative in neurosur-



**Arman Voskertchyan, Managing Director,
Johnson & Johnson Russia and CIS**

gery, e.g. chlorhexidine. The purchasing department of the state hospital prefers not to venture to include constraints referring to antibacterial characteristics of the material in its tender documentation fearing complaints of the producers who use chlorhexidine. As a consequence, the state hospital purchases the suture material which is completely unsuitable for neurosurgery and uses the material without antibacterial effect. Unfortunately, such situations are not uncommon. Not only does the patient suffer but the state hospital economics as a whole, because it is forced to spend additional funds to fight surgical site infections.

In implementing the policy of the healthcare system development and promotion of the competitiveness of state hospitals, it is necessary to align the regulation with the need to protect the interests of doctors, which will ultimately result in their patients' health protection. The leading opinion of the state hospital "internal customer" supported by the opinion of experts from medical organizations, clinical researches and medical economic models must be dominant at all stages of procurement process, including such stages as:

- procurement needs planning and preparation of specifications of the medical devices to be purchased;
- carrying out the tender involving evaluation of the medical devices offered by the bidders, their technical and functional (consumer-oriented) characteristics, safety and, the last but not the least, their performance in medical practice;
- checking the quality of the procured medical devices and evaluation of the budget spend cost efficiency.

The top priority in this respect should be given to the following measures:

- 1) Recommendations of the state regulators that would encourage purchasing medical devices on the basis of evaluation of their performance efficiency, which is currently practiced by some state hospitals.
- 2) Establishment of dedicated expert committees who will be trusted by medical professionals to elaborate general recommendations with respect to the medical devices procurement. The experts' opinion and the opinion of the doctors supported by the clinical researches must be the only true opinion of the required properties of the medical devices to be purchased.
- 3) Greater access to the information concerning approved medical devices, their characteristics and performance in clinical practice. Producers of medical devices or their authorized representatives who fail to present complete information about their products at the request of the state hospital, who conceal the data of clinical researches, shall not pretend to the right to supply their products to the state hospital. It is necessary to create effective measures which would prevent purchasing "a pig in a poke" by regulating the tender preparation process.

Harmonization of relationships between medical industry and healthcare institutions is an urgent task. At the same time, it is vital that key decisions are made in the framework of an open dialog of government regulators, medical professionals and business community, while recognition of the interests of all stakeholders should not compromise the primary goal of the state – provision of safe and efficient medical care and protection of patients' rights.

CONDUCTING TENDERS IN RUSSIA: KEY PITFALLS

Increasing regulatory pressure on international companies to comply with a swathe of anti-corruption and anti-money laundering legislation is felt acutely by foreign companies seeking to operate in Russia. Russia, at least in terms of perception, is a jurisdiction which presents a high risk for potential exposure to, or involvement in, corrupt schemes engineered by well-placed government officials, or fraudulent attacks by business partners and even a company's own employees.

International companies operating in Russia are particularly vulnerable to such schemes, in large part if they are unfamiliar with the local business environment. Control Risks works with its clients to provide a comprehensive understanding of the reputational risks linked to specific business sectors and individuals. There are a number of schemes employed time and again by local fraudsters, which if understood by our clients can lead to preventative action rather than accidental participation in these schemes.

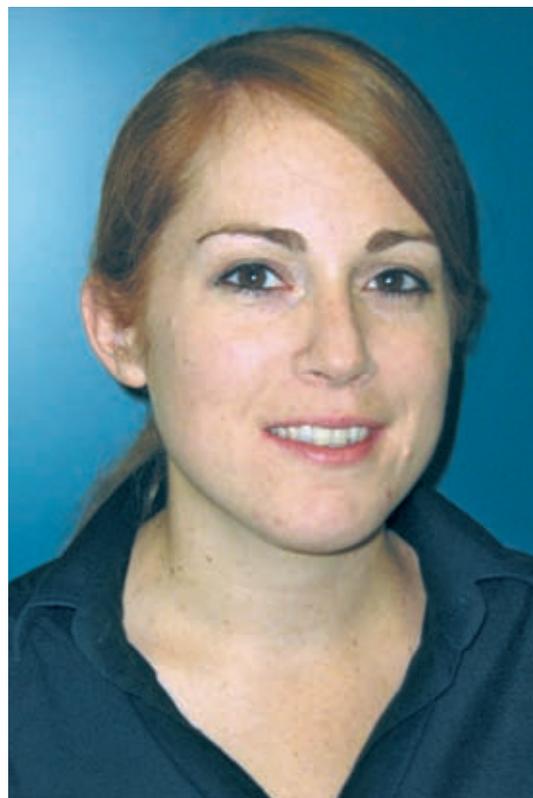
Many of these schemes are centred around the use of what are essentially shell companies, known as "one-day companies" in Russian, which are used to conceal the identity of the company's beneficiary, often for tax evasion reasons, to hide links to state officials, or conceal the interests of company employees.

The use of one-day companies is widespread in tenders conducted both by the state and by major corporations in Russia. They are used in tender fixing for a number of simple purposes.

- **To give the impression of transparency.** For example, if a quorum of four bidders is required in a tender forum, one bidder may use the services of three one-day companies to give the impression of a quorum. (This is sometimes done in collusion with competitors, who take turns using this practice to win bids).
- **To collude with a PEP.** It is not unknown for the government official running the tender to use one-day companies to help protect his preferred bidder – the one that has promised him a share of the proceeds, or to conceal his own interest in that company.

- **To conceal the interests of a company employee.** In B2B tenders, an employee of the company conducting the tender may take advantage of internal information on the potential deal to which other bidders do not have access, thereby ensuring that the one-day company representing their interests wins the contact at the highest possible price.

Both corruption and fraud therefore present significant risks when conducting tenders; although in Russia there are a number of key red flags which can alert us of these risks and, if assessed in their entirety, can suggest whether a bidder represents a real company which provides a genuine service. These are centred around 'know your customer' recommendations including the following:



Rosie Hawes,
Senior Consultant, Russia & CIS,
Corporate Investigation,
Control Risks

SOME SIMPLE STEPS TO TAKE WHEN CONDUCTING A TENDER IN RUSSIA

Carry out a site visit

One-day companies in Russia are usually registered, along with hundreds of other companies, at a mass-registration address. In our experience, a physical inspection of a mass-registration address will at best confirm it as a post office box and at worst as a bus station, swimming pool or another unrelated facility. A mass-registration address is also a telling indicator that the company registered there most likely conducts no real business of its own – a genuine entity should always provide a second or ‘actual’ address to a business partner. Visiting both addresses will help you to understand whether the company exists beyond its paper registration details.

This practice can be used in more transparent jurisdictions for reasons of simplicity and efficiency, or in keeping with those jurisdictions’ rules for company registration. In Russia, this is rarely the case. Here, mass registration addresses tend to be used to subvert the business registration process or to exploit loopholes toward illegal ends.

Who are the company’s shareholders and directors?

A Russian company must be registered against the passport details of its CEO, who is legally responsible for the company, and (where they exist) the shareholders. In our experience, however, more often than not these passport details are purchased from a student or pensioner only too pleased to make a bit of extra cash. In other cases, a stolen passport is enough to get the job done. Imagine the surprise of a pick-pocketing victim when he or she learns they are the CEO of several hundred companies, any number of which might be under investigation for tax evasion or other crimes committed in his or her name. Imagine as well the surprise of an international investor when he or she discovers his new

business partner is owned by a deceased individual residing at a hairdresser’s salon.

How long has the company been operating?

Consider the extent of the company’s experience. Companies with little or no established presence in the sector, or which are unable to demonstrate the combined experience of its employees may have never previously been active in the industry (if they do exist at all). This is not only a corruption risk but may also present operational challenges should they be successful.

Consider the links between the various participants

Are there obvious ties between those companies which have placed bids? Are they linked by address or shareholder for example? Although a basic red flag, in jurisdictions with less sophisticated means to monitor for potential fraud during the tender process, bidders become arrogant and lazy in their submission of fraudulent bids and assume that the entity conducting the bid will miss these obvious links which become apparent if you study bids attentively.

In the same way, a comparison of how bidders present their documentation may raise major concerns. If submissions from four different companies look virtually identical, this can be a red flag that the applications have been completed by the same individual, who represents all four companies.

Has a quorum been set and has it been met?

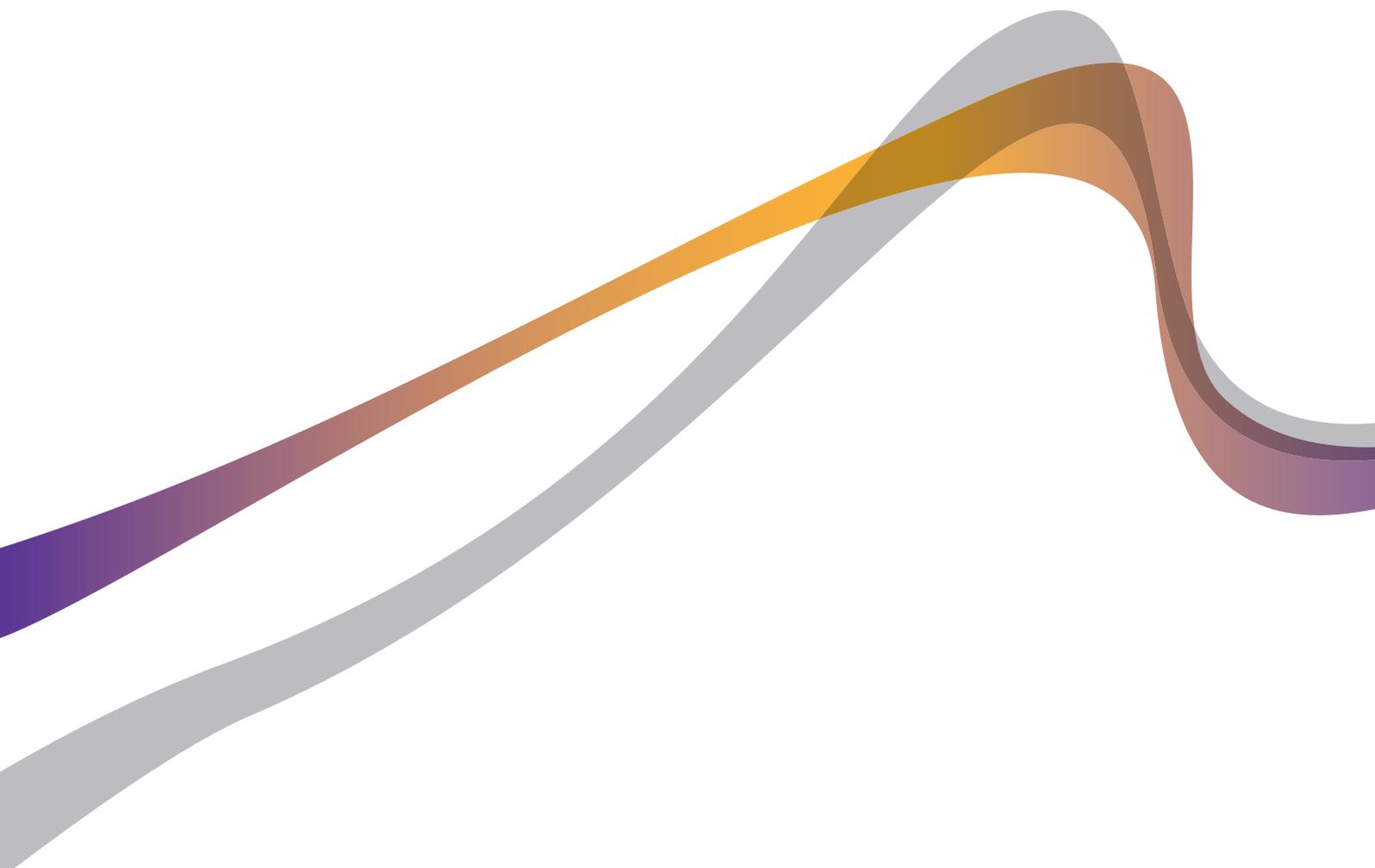
We describe above how a quorum can be manipulated via the use of one-day companies to give the impression that it has been met. Always be alert to the possibility that some or all of the bidders may be working in collusion to serve their own interests and boost the value of the tender, rather than to provide professional services at the best price.

Timeframe

Always ensure that there is a sufficient and reasonable timeframe from announcing the contract to actually conducting the tender. Disorganisation and short timeframes can be an excuse to rely on favoured suppliers and be used to justify a failure to announce a tender publicly. This makes the process particularly vulnerable to manipulation.

What is the value of the tender?

Dependent on the value of the tender and the kind of service the successful bidder is expected to provide, these guidelines can be further enhanced to include research and enquiries that go beyond a review of registration documents to include media checks and discussions with sources familiar with the bidder.



RECOMMENDATIONS ON IMPROVEMENT OF PUBLIC PROCUREMENT REGULATIONS AND PROCESSES DEVELOPED BY THE BUSINESS COMMUNITY

INDUSTRIAL COMPANIES WORKING GROUP: FIRST FINDINGS

On February 1, 2012, the meeting of IBLF Russia International Steering Committee for the first time considered the initiative of creating the Industrial Companies Working Group. The suggestion was to pool the efforts of various companies, non-government organizations and government officials in order to determine the guidelines and mechanisms of improving the procedures of public procurement and enhancing transparency and efficiency of tenders. The idea was supported by major corporate executives, representatives of the government, notably, Mr. Sharonov, Deputy Mayor of Moscow in the Moscow Government for Economic Policy



Yelena V. Abramova,
Head of Programme
Improvement of Business Standards in Russia
Branch Office IBLF in Russia

voiced the interest of the Moscow Government in the implementation of this initiative.

Areas of activity

At the very inception of the Group's work, the business community formulated a number of key problems arising in the process of public procurement:

- tailoring documentation to the needs of specific suppliers;
- vague and inadequate requirements specifications (SoWs);
- inability to participate in the public procurement without intermediaries due to inappropriateness of contracts and high risks.

Moscow Committee for Competitive Policy (Tender Committee) stated its request as follows: "Taking into consideration the IBLF initiative, we would be primarily interested in the position and suggestions in the following areas of improvement of the municipal purchasing:

- creating efficient system of auditing the process of initial contract pricing;
- developing measures to minimize single bidder tendering;
- building up of a transparent pricing system and the system of procurement in the sphere of housing services and utilities".

As a result, at the first meeting of the Group on March 2, 2012, the CEOs of several companies and the representatives of the Moscow City Tender Committee agreed to unite their efforts to complete the following:

- to analyse the draft law On Federal Contractual System in Procurement of Goods, Work and Services and prepare Group recommendations on its amendment;

- to study the tendering experience of various corporations in order to identify the mechanisms and schemes they use to protect themselves against corruption;
 - to study the procedures and organization of public procurement tenders in Moscow in order to identify their weak points;
 - to analyse the experience of companies participating in the process of public procurement in order to identify areas of concern in their organization;
 - to study tender procedures and organization in public procurement in the capital cities of other countries in order to identify mechanisms of counteracting fraudulent behaviour.
- Benchmarking Report: Procurement Framework, KPMG.
 - Remedies and Public Procurement. Laws in Europe, Baker & McKenzie.
 - OECD Inventory of Mechanisms, OECD.
 - Public procurement bill.
 - Draft Directive of the European Parliament and of the Council on public procurement in the European Union.
 - European Public Procurement Guide, Johnson & Johnson.
 - held 3 meetings where member organizations discussed the results of their joint activities.

The initiative involved 17 organizations: Siemens, General Electric, Philips, Emerson, Johnson & Johnson, TNK-BP, ABB Russia, Honeywell, FESCO, KPMG, Baker & McKenzie, Control Risks, IBLF, US Board of Trade in Russia, European Business Association, Russian Union of Industrialists and Entrepreneurs, Moscow City Committee for Competitive Policy (Tender Committee).

During the past three months the experts of the Group:

- analysed the draft law and on April 27 sent the resulting proposals to the Moscow City Tender Committee, Department for Regulatory Impact Assessment of the Ministry of Economic Development (in the framework of the Public Consultations on the draft law that were held from April 20 to May 4, 2012), Committee for Economic Policy, Innovative Development and Entrepreneurship of the RF State Duma, Committee for Promoting Competition of the Russian Union of Industrialists and Entrepreneurs;
- studied procurement organization in big companies through interviews and analysis of the experience of four companies;
- studied the procedures and organization of public procurement tenders in Moscow by interviewing three members of the Tender Committee and analysing the documents provided;
- analysed the practice of participation of three companies in public procurement processes;
- collected the following documents illustrating foreign experience:

Main conclusions and proposals

The comparative analysis of the problems facing the companies which participate in the processes of public procurement showed that similar difficulties are also experienced by the members of the Tender Committee. Both parties stressed:

- the low level of qualification and motivation of the customers' representatives who prepare the bid;
- inefficient planning and very short time for preparation of proposals and checking tender documentation;
- tender documentation cannot be properly checked because of the lack of relevant experts in the controlling bodies;
- absence of checkup (pre-qualification) of the supplier and any feedback about its performance;
- lack of transparency in the work of tender committees and their biased approach to suppliers' proposals and selection;
- public procurement organization shortcomings and technical flaws.

The business community drew special attention to the problems of contracting and contract performance, while the representatives of the Tender Committee described unfair behaviour of customers' agents¹.

On the majority of issues the views of the Moscow City Tender Committee and the business coincided and ultimately led to a common understanding of

¹ A more detailed analysis of the scope of problems is given in publication "Key challenges in relation to public procurement process", p. 36.

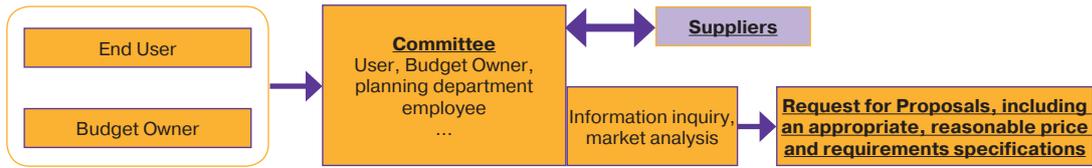


Fig. 1. The stages of designing requirements specifications by the government purchaser (as it should be)

the main problems: lack of skilled and properly motivated government officers and imperfections of the public procurement process. These general conclusions actually imply serious violations.

Let us illustrate the “general conclusions” with certain cases frequently encountered in the process of public procurement (Fig. 1).

Government purchasers, such as medical and education institutions, are allocated budget financing for their operations. The “budget owners” of state-funded institutions are their chief managers, i.e., the chief medical officer of a hospital or the school principal, while the “end users” are the professional staff of these institutions – doctors or teachers. Ideally, the latter have to agree upon the quantity and quality of the goods, materials and services required for their work with the “budget owner”. After the funding is approved, the entity has to assemble a purchasing committee (further Committee) including the end users – the employees, the CEO, the officer of the planning and economic department, and the law department officer. The Committee formulates the bid, i.e., the requirements specification (SoW) of the materials, goods and services to be procured, determines the amount of the funds to be allocated from the budget of the entity. This has to be done by joint efforts of all members of the Committee on the basis of the analysis of the potential suppliers market and evaluation of their proposals. The task of the Committee is to provide a “quality – price” trade-off because the representative of the “end user” in the Commission must make sure that the requirements specification does not block off the suppliers capable of providing the product or service required for its work, while the “budget owner” (head of the entity) is concerned about the optimum price. Other members of the Committee are responsible for the market analysis and handle the documentation which has to conform to the regulator’s requirements. If the Committee acts as described above, it will be able to make proper analysis of the suppliers’ proposals, estimate the price band and, hence, prepare reasonable and adequate tender documentation.

In practice, however, it turns out that doctors are required only to treat patients and teachers only to

give lessons. As a result, the Committee is frequently a mere ceremonial formation, all its functions being vested in one of its members, usually an officer of the planning and economic department, who is charged with the job of preparing dozens of bids (rather than just one) in addition to his/her principal duties. This person does not understand the details of the work of the “end user” (the professional). He or she is assigned by the boss (“budget owner”) the task to purchase the required goods or services at a lowest price. “The doctor won’t be able to write the requirements specification, let it be written by the supplier”, so the officer of the planning and economic department, who is not accountable for the outcome of the end user’s work and is often even not personally acquainted with the end user (thus having no moral obligations), takes the path of least resistance and asks the supplier to write the bid. Needless to say, the latter is concerned with its’ own interests, thus the requirements specification submitted to the government bodies for approval is completely tailored to the needs of the given supplier (Fig. 2).

There are regulators which must check the tender documentation and preclude any distortion of competition. Unfortunately, the checkup is often inefficient. The members of the Tender Committee, checking the compliance of the documents with the requirements of the legislation, often work in the crunch. Sometimes they are forced to try and reconcile contradictory requirements of different regulators. The Tender Committee does not include experts who are capable of checking the bid from the point of view of any discriminatory factors or any excessive requirements to the supplier; no such experts are in the Selection Committee either. The latter often makes its decisions being short of some members, and the customer representative always enjoys a casting vote. When the tender results are announced, only the names of the participants and their pricing quotes are disclosed, while any information on the products purchased at the said price remains non-public. Therefore, even external observers do not obtain sufficient information to assess the validity of the choice made by the Committee.

Neither the Federal Antimonopoly Service (FAS) nor the Tender Committee have any experts to carry out qualified independent evaluation of requirements



Fig. 2. The process of designing requirements specifications by the government purchaser (in practice)

specifications. Litigation is avoided both by customers and suppliers. As a rule, by the time the claim is examined by the court, the tender has ended and the case is closed due to absence of grounds – the supplier incurs losses but does not take satisfaction. During the whole period of the court proceedings the customer’s budget is “frozen”, which threatens its ability to work.

The end users, should they try to exercise their control powers, cannot succeed because of the absence of any regulated procedure of checking the quality of the product and of any standard form of claims with respect to the quality/quantity of the product.

Thus, no control or regulation is possible at any stage of the procurement – from preparation of the bid to quality assessment.

However, we have only described a part of the situation – i.e. the relations between the government purchaser and the supplier in the course of preparation of tender documentation. Careful examination shows that the supplier is not, as a rule, the producer of the procured product, but acts as a middleman (Fig. 3).

Producers, especially those who manufacture equipment, machinery or provide high-tech services, are afraid to participate in the public procurement directly. Their apprehension is caused by the

fact that often the customer cannot properly manage projects while contracts are far from perfect: high delivery risks with poor accountability of the customer. Trying to cut their risks but fearing to lose the market, producers engage intermediaries.

Now, let us remember that public procurement does not stipulate checkup (pre-qualification) of the participants, i.e., tenders can involve several affiliated (owned by one person) suppliers with different price quotes. Thus, an intermediary firm can submit to the tender different proposals of several big producers and it can additionally represent dumping proposals of companies selling worse products. And, if the intermediary helps the government customer to design the bid and requirements specification, it actually turns out to be the only suitable supplier, i.e. competition is done away with. The procedures are observed, more than one firm take part in the tender, but actually everything has been decided beforehand – the intermediary firm “regulates” the market in its own interests. As a matter of fact, it fills the gap which should be occupied by the regulator. In this situation everybody loses: producers cannot control the intermediary (uncertainty of the market position), they risk their reputation and are answerable to international regulators. Losses are incurred by the government customers as well: the risk of contractual failure is high, sub-standard products are supplied at excessive price.

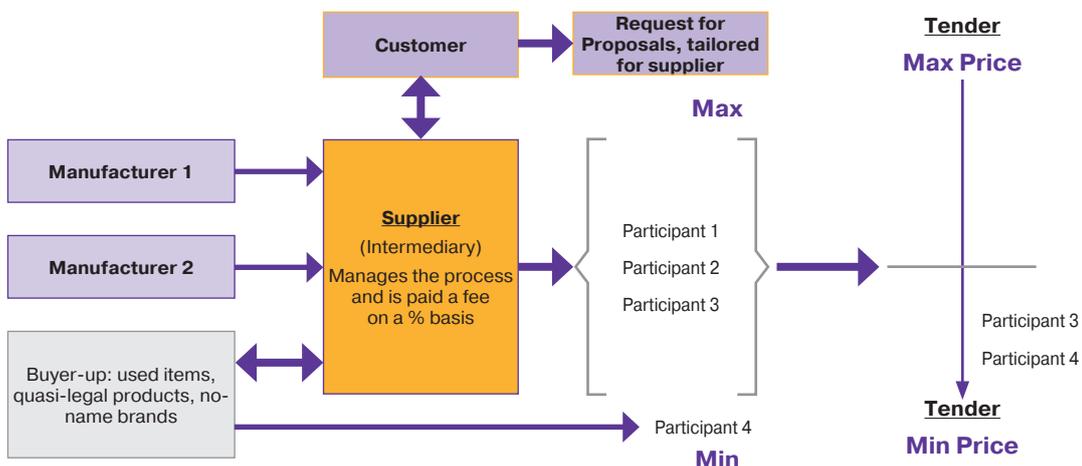


Fig. 3. Producer’s role in public procurement

Thus, having analysed the public procurement process and procedures, the Group has identified the following inherent problems:

1. There is no real competition – there is a mock competition.

Low skills and low motivation as well as pure irresponsibility urge the Customer to take the “soft option” of collusion. Lack of qualified staff in the regulating bodies, procedural flaws of planning, proposal evaluation and comprehensive prequalification of suppliers prevent discovery of the collusion.

2. There is no “solicitor” for the “end user” – nobody takes care to ensure that its interests are met.

The aim of the public procurement is to execute the budget within the limits of the law. There isn’t any process of “purchase” and its “owner”:
«There are persons responsible for the budget execution but nobody is responsible for purchasing the things which are needed by the “end user”».

3. Government representatives participating in public procurement do not share common goals.

The Key Performance Indicators (KPIs) of the end user (head of the organization), the officer of the planning and economic department and the regulating bodies are not linked to the procurement results – they are differently directed, “sailing different boats in different directions”. These system-defined problems are not accidental. They stem from the federal legislation in force. Unfortunately, the draft law On Federal Purchasing System in Procurement of Goods, Work and Services fails to provide solutions either¹.

4. The draft law fails to protect the end user of goods/services.

Notably, part 1 of Article 19 provides criteria for appraising the validity of the procurement, including its conformance to the respective functions. But the draft law lacks direct stipulation of the necessity to validate the customer’s needs. The list of circumstances due to be validated in the course of designing the procurement plan (part 2 of Article 19) does not include the cus-

tomers’ needs. The Provisions regulating the process of formation of procurement schedules fail to fill this gap. Nor does the draft law introduce any mechanism of transforming the customer’s needs into the respective requirements specification.

5. The draft law practically fails to ensure selection of adequate suppliers (prequalification).

It should be admitted that paragraph 9 part 1 Article 31 of the draft law vests the Russian Government with the right to establish additional requirements to suppliers: availability of financial resources, managerial skills, experience and business reputation as well as labour resources to fulfil the contract. But, in fact, the draft law does not contain any description of the prequalification procedure or specific terms and conditions.

6. The draft law fails to ensure transparency and control of public procurement.

Although the draft law declares the necessity of producing standard forms and contracts, there is mention neither of the persons to be in charge of their preparation nor of specific procedures of interaction and information exchange, deadlines, accountability or motivation of the performers.

As a follow up of the examination and analysis of the weak points of the public procurement, the Group has prepared its recommendations for the improvement of the process, which are presented in the materials attached. Hence, only the main suggestions of the Group are listed below²:

- to introduce an agency or a service designed to ensure the efficiency of procurement at all stages (“solicitor” of the end user); a “procurement department” to ensure procurement of the goods and services required for the end users to meet their CPIs, with optimum properties, at optimum market price, taking into account the total cost of ownership;
- to group the procurement processes into three standard categories:
 - **direct procurement** – the customer pur-

1 More detailed account of the analysis of Draft Law On Federal Purchasing System in Procurement of Goods, Work and Services is given in the publication “Opinion of Industrial Companies Working Group on Draft Federal Law On Federal Contract System in State Procurement of Goods, Work and Services (Russian Ministry of Economic Development)”, p. 28.

2 Industrial Companies Working Group: Proposals and recommendations, p. 39.

chases goods and services without tendering in force majeure situations and/or within minimum budget (the budget owner has only small budget funds at its disposal);

- **regular procurement of standard goods and services with tendering** – standard goods and services whose quality and quantity are fixed (they are purchased on an annual basis, can be classified and standardized), while the price is not subject to substantial fluctuation;
- **procurement of complex/unique goods and services by competitive bidding** - the properties and price of the goods/services must be determined upon qualified evaluation of the need on the part of the supplier, the price is high and depends on the complexity of the unique contract performance, the delivery requires special conditions and preparation on the part of the customer.

- introduce “prequalification” of suppliers; the extent of suppliers audit (and, accordingly, the bodies and services engaged in such audit) will depend on the procurement budget and the risk of poor contract performance. Each procurement category will require its own appropriate audit extent;
- introduce a civic watch body that would make surveys of the market players identifying the aspects to be improved, prepare quarterly recommendations, analyse complaints, check (recheck) procurement processes and assist in resolving disputes by the “Procurement Department”.

To conclude, we would like to note that the Group is carrying on its work and this publication is designed to show the findings obtained so far in order to make them available to a wider circle of professionals and experts interested in improving the public procurement processes.

OPINION OF THE INDUSTRIAL COMPANIES WORKING GROUP ON THE DRAFT FEDERAL LAW ON FEDERAL CONTRACT SYSTEM IN STATE PROCUREMENT OF GOODS, WORKS AND SERVICES (RUSSIAN MINISTRY OF ECONOMIC DEVELOPMENT)

Having examined the Draft Federal Law on Contract System in State Procurement of Goods, Works and Services developed by the Russian Ministry of Economic Development, the Industrial Companies Working Group (ICWG) has come to the following conclusion.

The manifest advantage of the Draft Law is that it stipulates uniform regulation of all stages of the state procurement process. The Draft Law envisages public control and monitoring of procurement activities as well as a number of other processes and stages not regulated by current Federal Law No.94.

Appreciating all the merits of the Draft Law, we find it necessary to draw attention of the legislators to the aspects which, in our view, have not been taken into account or have been insufficiently elaborated upon in the document under investigation.

In particular, the Group focuses on the following points:

1. The Draft Law does not properly protect the needs of the end user of goods/services.

In our opinion, the end user of goods/services should be involved in the procurement process by active participation in decision making at the stages of formulation of a Statement of Work (SoW), assessment of commercial bids, choice of supplier, closing of contract and acceptance of goods/services. The given Draft Law neither provides for involvement of the end user organizationally nor does it give any motivation of such involvement.

As before, the Draft Law fails to address the issue of transformation of the users' actual needs into SoW (and accordingly, it does not introduce any adequate mechanisms and procedures).

It is also necessary to set up a system of gathering information about the end user satisfaction and to include this information in the suppliers' qualification.

Special attention should be paid to the validation of the end user's needs (meaning the persons for whom the goods are purchased within the frame-

work of public procurement procedures rather than those who arrange such procedures), because determination of the customer's actual needs is crucial for the procurement system efficiency. Wrong identification of the needs results in overstated or understated requirements to the goods to be purchased in order to meet those needs, thus distorting all subsequent stages of tendering. The relevancy of the needs declared by the customer shall be justified by the activities to be provided with the procured goods.

The Draft Law does not expressly stipulate the requirements to the substantiation of the customer's needs. The Draft Law envisages justification of the purchase at the stage of procurement planning. Article 19, Part 1, lists the criteria used for assessment of the purchase relevancy, one of them being its ability to fulfill the functions for which the goods are purchased.

Thus, the mechanisms required to substantiate the customer's needs are actually in place. Nevertheless, they are offset by the absence of direct stipulation that the customers' needs are to be substantiated. Moreover, the list of circumstances which, according to Article 19, Part 2, are to be substantiated in the process of the procurement planning does not include the customer's needs. This gap is not filled by the Regulations for planning and scheduling tenders either.

Therefore, the provisions of Article 20 on rationing cannot be fully realized since the excessive requirements to the goods/services to be procured will be assessed on the basis of the customer's claimed needs even though they may be actually overstated.

Thus, we suggest that Part 2 of Article 19 should contain the requirement to substantiate the customer's needs at the stage of procurement planning.

2. The Draft Law fails to ensure proper selection of suppliers capable of performing the contract with due quality.

In the Group's opinion, the mechanism and criteria of pre-qualification of tender participants should be

elaborated upon in greater detail by clearly regulating the legal, financial and technical (technological) aspects of the qualification.

The requirements to suppliers are vital because even if all specifications fully conform to the actual needs of the customer, the procurement efficiency depends on the proper execution of the contract, directly affected by the supplier's personality.

Article 31 Part 1 Clause 9 of the Draft Law vests in the Russian government the right to establish additional requirements to suppliers, including those that refer to financial resources necessary to perform the contract, availability of equipment and other material resources, managerial skills, experience and business reputation, as well as labour resources necessary for performing the contract.

As a whole, we appreciate this initiative, although we believe that some of those additional requirements could be included into the Draft Law itself.

In particular, we suggest that the Draft Law should stipulate that the supplier: shall not be registered at a mass registration address; shall be established in the industry and have relevant experience; shall not be affiliated to any other participant of the procurement procedure; shall not have conflict of interest with the customer (or any employee thereof).

It is also necessary to ensure that customers could carry out, or employ experts to carry out, an independent professional expert examination of the goods and services to be procured at their request.

3. Transparency and control over state procurement are not sufficiently assured.

The Group believes that the corruption risks of the Law can be reduced by standardization and classification of the procured goods and services. This will also enhance control over the process.

Introducing standard forms and contracts will promote efficiency, accountability and transparency of the process. Unfortunately, while the present Draft declares the necessity to develop

standard forms and contracts, it does not define the persons responsible for such development or the deadlines of the work.

Complete automation will enable an increase in the operational efficiency, minimize the risks of a bidder's disqualification due to technical errors and remove the barriers for participation of peripheral bidders.

Many procedures and processes are properly declared in the Draft Law but they are not elaborated upon from the point of view of participants' interaction and information exchange, accountability and motivation as well as reporting deadlines.

Industrial Companies Working Group (ICWG): Detailed comments and recommendations for further elaboration of the Draft Law.

Comments on the Draft Law as a whole

The Draft Law contains a number of reference rules, including references to subordinate legislation, without stating the deadlines of adoption of such regulatory documents.

For example, Article 5 Clause 4

Operational procedure of the unified information system, technological and linguistic requirements to the unified information system, including reliability requirements, and procedure of integrating the unified information system with other information systems shall be determined by the Government of the Russian Federation.

The referenced regulations are contained in the following articles of the Draft Law: Art. 5, 13, 17, 18, 20, 21, 22, 24, 26, 29, 30, 31, 32, 33, 34, 41, 54, 73, 78, 85, 88, 89, 93, 96, 99.

It is necessary to specify the procedures (or, at least, the minimum requirements to such procedures) of preparation of the regulatory document by the respective government body and state the deadline for its presentation.

In working out the Draft Law and determining its effective date it is necessary to envisage a certain

transition period during which all secondary legislation is to be developed and amendments introduced in other respective federal laws.

Individual articles contradict each other and some issues are not regulated

The provisions of Art. 51 and 53 of the Draft Law should be harmonized by amending Art. 51 as follows: "... except for the cases stipulated by Clause 2, Part 2 Article 53 hereof":

Article 51: Negotiations between the consumer and the bidder with regard to the bids, including the bid submitted by this participant, shall not be allowed before the results of the tender are finalized and the winner is named.

Article 53 Part 2 Clause 2: To clarify certain characteristics of the items to be procured it is necessary to arrange discussions with suppliers (contractors).

If negotiations with potential suppliers are deemed to be necessary, they shall involve both the contracting body and the representatives of supervisory departments, end users or consumers.

Industrial Companies Working Group (ICWG): Detailed comments and recommendations for further elaboration of the Draft Law

Chapter 1. General Provisions

Article 4. Public Control Issues.

Determine specific rights of public control bodies, the procedure of filing applications or claims and legal consequences of filing such applications/claims.

Determine the procedure of filing claims and their examination by public associations, possible legal consequences of such examination. Envisage the possibility of filing claims electronically.

Article 5. Unified Information System.

1. Specify the list of data with restricted access and clearly explain such restrictions.
2. Make publicly available any information which is not included in the restricted list.
3. Regulate with respective acts the creation of the unified information system (UIS) and the procedure of its use – the date of adoption of such regulatory acts is not stipulated.
4. Specify the procedure of integrating the UIS with the existing system <http://zakupki.gov.ru>.
5. Make available all information on registration and product characteristics to the market – information on registration certificates and conformity certificates has to be posted to the web sites of official sources or to be found through the search engines of the UIS.

Article 13. Excessive regulation. Article 13 Clause 2. The authorized body is charged with superfluous function of keeping the register of foreign countries having international treaties. The issue refers to the administration of the UIS and shall not be regulated by the federal law.

Chapter 2. Planning and Forecasting

Article 21. Any possibility of including unexpected and urgent bids in the Schedule shall be eliminated. Specify the time required for purchasing specific goods or services (e.g., procurement of school desks of a certain make shall be three weeks, procurement of sophisticated equipment, one year). Specify the time within which the customer has to provide information on procurement of specific types of goods/services and make it impossible to file a bid earlier than the stipulated date.

Prepare a public procurement plan for the coming year, which will allow potential bidders to determine precisely whether they would be able to participate in this or that tender.

Article 22. Risk that the members of the selection committee quote the starting price that is not adequate for the procured goods/services.

Strictly regulate and differentiate the use of various methods of estimating the starting (maximum)

contract value. Procurement of the product categories whose purchase promotes the implementation of the strategic goals and aims envisaged by the Russian Government shall be primarily made with the help of the procurement methods which are based on comprehensive assessment of the bidders using every possible criterion.

Chapter 3. Procurement Process

Article 24. For each method of identifying suppliers a respective scope of application must be determined and regulated (what method shall be applied for which categories of goods or services).

Article 31 Part 1 Clause 9. Some concepts and criteria are not adequately defined – assessment can be biased.

It is necessary to introduce strict definitions of the following concepts:

- a) availability of financial resources for contract execution;
- b) availability of equipment and other material resources for contract execution;
- c) experience and business reputation;
- d) labour resources for contract execution.

Omit the following item:

- e) managerial competence.

Article 32 Part 1 Clause 1. Criterion “contract value” shall be substituted by “total cost of ownership”¹.

Revise the criteria “contract value” and “expenses incurred in the maintenance and repair of goods, in the use of the works” and their weight in assessment.

We recommend the following approach for procurement of goods which would promote implementation of the strategic goals and aims envisaged by the Russian Government:

The bids are to be evaluated on the basis of two key criteria: the unified criterion “Total cost of ownership”¹ (combination of criterion No. 1 “Contract value”, No. 2 “Expenses incurred in maintenance and repair of goods, in the use of the works”, No. 5 “Warranty terms with respect to the procured item”).

Exclude criterion No. 3 “Time of goods delivery, work completion, service provision” from assessment and include it in the statement of work;

Criterion No. 4 “Quality, functional and environmental characteristics of the procured item” (the weight of this criterion must be at least 35%).

Criterion No. 6 “Qualification of the procurement process participants” must be accompanied in the Draft Law by a clear-cut list of sub-criteria.

Article 34. Contract.

1. Use the description of the contract subject matter suggested by the Draft Law of the Federal Anti-monopoly Service, which helps to distinguish the cost of the procured product from the cost of the accompanying services.
2. Distinguish between the security for contract execution during the time of work performance and that for the warranty period and provide for the possibility to claim the security in each event of non-performance or improper performance of the contract (art.33).
3. Establish the only variant of contract execution security in the form of security deposit.
4. Develop government master contracts based on the groups of procured goods/services.

In case of sophisticated equipment or comprehensive projects or construction, contract conclusion must involve the following measures intended to protect the supplier:

- secure the financial position of the contract – guarantee of a creditable state-owned bank;

¹ Total cost of ownership (TCO) is a method intended to determine the product costs incurred at all stages of the product life cycle (starting cost, maintenance, operating and utilization costs). The total cost of ownership improves the efficiency of the bid assessment, thus ensuring the purchase of really best products according to the cost/quality ratio.

- divide the contract execution into individual stages;
- ensure the customer's liability for delays in preparation of the premises and in acceptance of equipment;
- any additional expenses incurred by the supplier due to irresponsible behaviour of the customer shall be compensated.

Open tender – flaws in description of procedures and conditions

Article 35 Part 2. Elaborate or omit for fear of broad interpretation of the notion of “force majeure circumstances”.

Article 36. Rejection of a bid with a dumping price – sets the limit of price reduction (25%).

Bids with dumping prices shall be accepted on condition of increased security deposit (on this matter the proposal of the FAS Draft Law can be used).

Introduce provisions stipulating that the customer, prior to closing the contract, can demand from the winner the evidence of their being able to execute the contract on the terms proposed thereby (Clause 6).

Article 39. Notice of procurement (Clause 5): “time, place and procedure of submitting bids (offers) by the participants of the procurement procedures”.

Establish that the date and time of submitting bids stated in the UIS is the basic date (to be taken as the reference time by all participants) and define what time is meant – the customer's, the operator's or Moscow time.

Article 40. Open tender – omit the payment for submitting tender documentation.

Article 45 Part 8. Determine the actions of a bidder related to changing or revoking its bid: how the participant can change the bid (deliver the changes in a closed envelope to be opened, submit the changes at any time in an additional envelope).

Establish the time period (say, within five working days) and the method (by e-mail, fax, etc.) for the

customer to send to the participants a request asking to extend the term of validity of the bid and the respective explanation.

Article 47 Part 3. Introduce a specific form for altering the bid and include it in the list of tender documentation.

Article 47 Part 5. We suggest the following wording: “During the procedure of opening the envelopes containing the bids the following information is announced and recorded in a special protocol: the date, time and place of opening the envelopes, the name of the member of the committee who opened the envelopes, the names of all members of the committee attending the opening procedure, the names of the tender participants, the name of the entity or individual and the mail address of such participant whose envelope with the bid is opened, the LIST OF ALL data and documents stipulated by the tender documentation, the terms and conditions of the contract performance stated in such a bid and being the criteria of assessment of the bids. If upon expiry of the period provided for submitting the bids only one bid is submitted or no bids are submitted, the tender shall be declared to be void and the respective information shall be duly recorded”.

In the course of opening the bids not only the participants and their quotes but also the goods/services offered thereby shall be announced.

Establish who (the organizer or the customer) delivers the records and the draft contract to the winner and in what manner they are delivered. Stipulate the liability of the body delivering the documents for proper delivery of the data.

Large commercial organizations, for example, use the following mechanism:

- *the date of the committee meeting is known to all participants, they can attend or send their representatives to act as observers;*
- *the results of the tender are made available to unsuccessful participants during the day following the date of opening the envelopes. They are entitled to contest the results (sup-*

ported by evidence) within three working days;

- should any complaints come in, the procurement process is suspended for the period of their examination, although not longer than for one week. All participants are duly notified;
- should the complaint be confirmed, the results are revised;
- if the complaint is denied, the winner is informed of the committee decision in its favour.

Article 49. Contract closing according to the results of the tender.

Add a point on the possibility of closing a government contract with the sole participant whose bid meets the requirements of the tender.

Article 52 Part 4. Examination of the bid needs longer time.

We suggest the following wording: “The notice of restricted tendering shall be posted to the Unified Information System at least thirty days before the day of opening the bids for participation in pre-qualification and shall contain the following information:...”.

The Draft Law stipulates that restricted tendering is arranged for procurement of goods (services, works) in view of their highly sophisticated or highly specialized nature. The list of circumstances when goods (works, services) are referred to this category is compiled by the Russian Government by enumerating the reasons why a certain product can be included in the category of highly sophisticated goods (but not any specific lists of goods). Consequently, the final decision on restricted tendering will be made by the customer themselves, which will result in lower competition. The suggested procedure shall be excluded or the list of goods shall be precisely specified.

Electronic auction

Article 59 Part 2 Clause 3. Time shall be specified as Moscow time with respect to the “date and time of expiry of the period of submitting bids for electronic auction”.

Article 60 Part 1. The Article restricts the period of submitting bids – a longer period is needed for examination of the bids. We suggest: “The notice of electronic auction is posted by the customer to the Unified Information System at least twenty days before the date of expiry of the period of submitting bids for participation in the electronic auction”.

Article 60 Part 7. Suggested wording: “The customer on their own initiative or in response to the request to clarify the provisions of the documentation on electronic auction can make decision to alter the documentation on electronic auction not later than three working days before the date of expiry of the period of submitting bids for participation in the electronic auction”.

Article 61 Part 1. Suggested wording: “In order to participate in the electronic auction, the participant accredited at the electronic trading platform, having furnished security of the bid (according to the requirements of the auction notice and auction documentation), shall submit a request to participate in the electronic auction”.

Article 61 Part 7. Suggested wording: “The participant of the electronic auction accredited at the electronic trading platform, having furnished security of the bid (according to the requirements of the auction notice and auction documentation), can submit a request to participate in the electronic auction at any moment from the date of the notice about the electronic auction until the date and time of expiry of the period of submitting bids, as stipulated by the respective documentation on electronic auction”.

Article 63 Part 2. Suggested wording: “The time of beginning of the electronic auction shall be set by the operator of the electronic trading platform according to the participant’s local time”.

Article 65 Part 2. Suggested wording: “The customer shall, within five days from the date of posting to the Unified Information System of the protocol stipulated by Article 62 Part 8 of this Federal Law, send to the winner of the electronic auction without the customer’s signature...”.

The liability of the customer for delay in providing the winner with the draft contract, signing the required documents, etc. shall be properly specified.

It is necessary to establish the only web site (Unified Information System) which will be used by all participants as the true source of information, including events of any disputes.

Article 65 Part 8. The mechanism of returning the security deposit is not determined. Suggested wording: "... the security deposit shall be returned to the auction winner within five working days from the date of concluding a contract with the winner from the receipt of the request to return the security deposit".

Chapter 5. Appeals and pre-trial dispute settlement

Article 97. Reasons for including/excluding suppliers in the register of unscrupulous suppliers shall be clearly stated. Omissions shall be taken into following consideration.

The Draft Law envisages the following reasons for including suppliers in the register (Art.97 Part 2): "The register of unscrupulous suppliers shall include information on the procurement participants who evaded closing the contract and on the suppliers (contractors) whose contracts were terminated by court decision or for cause".

The above provision fails to take into account the following cases:

- a) the contract is terminated by court decision at the suit of the supplier;
- b) signing of the contract is evaded due to technical reasons (delay in document exchange);
- c) the contract is terminated by the supplier for cause due to the customer's default;
- d) the contract is terminated by the customer for cause but there is a civil law dispute examined by the court.

In fact, according to Point "d", the regulatory body is vested with the power to include any supplier in the register if unscrupulous suppliers irrespective of civil law disputes and the respective court judgments.

Mechanisms of protecting supplier's reputation should be stipulated by following methods. It is assumed that contesting the actions/omission of public authorities will conform to the common rules with respect to the time of such contesting, which starts from the date when the supplier is entered in the register. Taking into consideration that the Draft Law does not stipulate any system of direct notification of the supplier about such event, one can perceive potential impairment of the supplier's right for defence. It is recommended:

- to envisage a system whereby the supplier is notified on being entered in such register;
- to stipulate the precise date upon which the supplier included in the register of unscrupulous suppliers is entitled to contest such decision;
- to stipulate a mechanism of assessment and compensation for the supplier's losses incurred by unlawful inclusion in such register;
- to stipulate generation of the register of unscrupulous suppliers;
- to identify the body which would compile such registers and the liability of the respective staff;
- to determine a mechanism and procedure of showing the results of Monitoring in the registers.

Article 99. Settling claims.

We suggest the following amendment to the procedure of considering claims contesting the results of tenders / auctions after the envelopes are opened:

- During the time when the claim is examined all procedures referring to the given procurement shall be suspended.
- The fact of the procurement suspension and the anticipated time of the claim examination shall be communicated to all participants of the process.
- The composition of the collective body examining claims shall be established.

Chapter 6. Final and transitional provisions

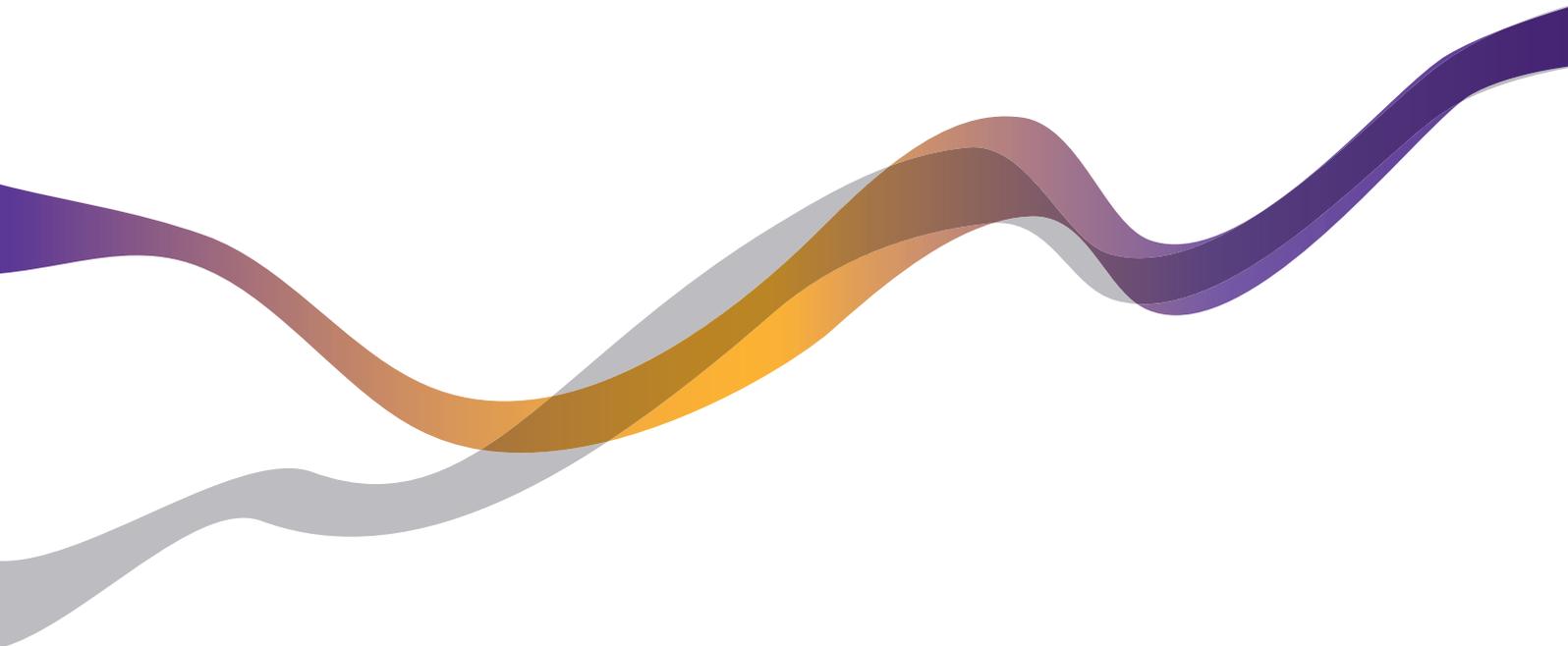
It is necessary to envisage a procedure of applying the national treatment during the transition period, since this Federal Law shall be en-

acted upon expiry of 12 months from the date of its official publication, except for Article 13 (National Treatment) and the first sentence of the third paragraph of Part 3 Article 37 (Contract Service) which shall come into effect one year after the enactment of this Federal Law.

Meanwhile, Article 103 of the Draft Law stipulates abolition of Federal Law No.94-FZ now in force which currently regulates, in particular, the application of the national treatment with respect to the goods of foreign origin.

Determine specific deadlines of development of standard documents and the minimum set of respective requirements.

The Draft Law stipulates the use of documents (both routine documents/reports and those related to specific procurement process), including Standard Contract Forms. However, according to Article 101 Part 5, until the federal executive bodies adopt standard contracts under the provisions of Article 34 Part 7 of the Draft Law, customers can develop their own draft contracts.



KEY CHALLENGES IN RELATION TO PUBLIC PROCUREMENT PROCESS

During the three months from March to May, 2012, the International Companies Working Group (ICWG) carried out a series of interviews with representatives of the Committee on Competition Policy (Tender Committee) of the Moscow Government and with companies' experts responsible for the participation of their companies in public procurement. Existing procedures and process organization of the tender for public contracts in Moscow have been studied and analysed. This has revealed weaknesses

that allow unfair behaviour on both sides of the public procurement process. The experience of companies in public procurement has been studied, highlighting the most sensitive aspects that prevent direct participation by companies in the public procurement process (leaving out intermediaries). It has also described the cases of unfair behaviour displayed both by companies and by governmental authorities. Detailed description of the challenge scope is described in the table below.

Problems mentioned by the participants of public procurement process

Moscow Tender Committee	Business Community
Low qualification and motivation of the bidder representative preparing the bid, including Statement of Work (SoW):	
<p>Collusion of customer / contracting organization and supplier: "doctors won't write the SoW, the SoW will be written by the supplier".</p> <p>Unreasonable requirements regarding the goods (services) to be purchased.</p> <p>Inadequate starting pricing.</p>	<p>Statement of Work (SoW) is tailored for a specific bidder, thus cutting off the others.</p> <p>Real needs are difficult to assess according to the SoW.</p> <p>Customers know little about new technologies.</p> <p>Price is determined by a number of factors, thus a precise tender request is important – it is difficult to respond correctly to the request for quote without knowing the details of the need.</p>
Planning is ineffective:	
<p>Contracting organizations send their requests at the last moment and there is no time to check or refine all the details.</p>	<p>The short time available for preparation and submission of the commercial bid is not enough to elaborate upon it properly.</p>

Moscow Tender Committee	Business Community
Inadequate examination of tender documents:	
<p>Lack of time for assessment of the bid and documents.</p> <p>No experts to examine the SoW.</p> <p>Nothing but compliance with the Federal Law 94-FZ is examined.</p> <p>Contradictory requirements to the documents and bids stipulated by different bodies.</p>	<p>The Federal Antimonopoly Service cannot scrupulously examine complaints about unfair competition (e.g., in case of complaints about SoW) due to the lack of qualified experts.</p>
No adequate check of suppliers and lack of feedback on their performance:	
<p>No assessment of suppliers' affiliation, law compliance, experience, technical possibilities to perform the contract.</p> <p>Only formal aspects are examined: licences, closing of contract, timely signing of acts.</p> <p>No tracing of quality of previous performance or, at least, judicial track record, which is not in the interests of the customer and supplier.</p>	<p>Bidders do not provide true information about themselves or their goods (e.g., lowering price by supplying second-hand products).</p> <p>Contract can be awarded to a bidder with no proper experience or qualification.</p> <p>Lack of proper procedure prevents from appealing against the customer: trial drags on while the auction is over.</p>
Inadequate assessment of bids and choice of suppliers:	
<p>The selection committee makes decision in the absence of some members – which is arranged for purpose: “this member has been urgently called somewhere”.</p> <p>The choice is made primarily on the basis of the price.</p> <p>The board of the committee allows the awarding of the contract to a certain supplier because the customer’s representative chairs the committee and has the casting vote.</p>	<p>The model of assessing bids is not always transparent.</p> <p>Quality and maintenance are not included in the assessment: quality is more expensive.</p> <p>The total cost of ownership is not taken into account: the product may have low price while being expensive in maintenance.</p> <p>The selection committee does not include experts capable of proper assessment of the bid.</p> <p>Only bidders and their quotes are announced, while their goods or services are not. The bidders are not sure of the proper choice.</p>

Moscow Tender Committee	Business Community
Problems involved in closing and performing contracts:	
<p>Contracts can be awarded to bidders incapable of performing them in a proper way.</p>	<p>Contracts do not expressly stipulate the customer's obligations – conditions for procurement are not provided.</p> <p>It is impossible to amend contracts – market players are not protected.</p> <p>There is no proper procedure of controlling quality in the course of procurement.</p> <p>There is no standard document regulating claims with respect to quality/quantity of products.</p> <p>There are no regulations for unit pricing in a government contract – contract specifications must stipulate correspondence of unit prices with the price which is taken into account by the customer when calculating the starting maximum contract value.</p>
Organization flaws and technical problems:	
<p>No comprehensive system of control over all stages of procurement process.</p> <p>Nobody evaluates efficiency of procurement.</p> <p>Technical glitches, technical problems of tendering.</p>	<p>No project management on the part of the customer (stages, liability, payment for completion of individual stages).</p> <p>Quality of procedure: lack of professionalism, motivation, structuredness, responsibility, poor control and feedback.</p> <p>Absence of an integrated electronic facility for potential bidders entails additional resources for data processing.</p>
Unfair behaviour of bidders:	
<p>Limiting access to public information.</p> <p>Blocking access to electronic auctions.</p> <p>Disclosing information about bidders.</p> <p>Instead of 50 million ruble order (additional control) 2 orders x 25 million rubles are offered (no additional control).</p>	

INDUSTRIAL COMPANIES WORKING GROUP: PROPOSALS AND RECOMMENDATIONS

We deem it necessary to develop an organization structure to ensure efficient implementation of the state procurement processes which have not been properly supported by any authority up to now: needs design and justification, planning, supplier prequalification, information exchange among all participants of the process as well as quality control and provision of adequate technical expert examination.

The Group suggests considering the following possibilities:

- I. To introduce an authority/structure, "Procurement Department", to enhance the efficiency of the state procurement processes.
- II. To introduce a public control authority.
- III. The Group suggests considering the possibility of implementing a process to be called "Suppliers' Prequalification".

The extent of auditing suppliers (and, accordingly, the departments involved) should be determined by the purchase budget and degree of risk of improper fulfillment of the contract. Each type of procurement stipulates specific extent of audit.

- IV. Procurement processes should be classified into three standard categories:

- **direct procurement** – the customer purchases goods and services without auction or tender in case of force-majeure (urgent need) and/or within the limits of the minimum budget (the "budget owner" has a modest amount at its disposal);
- **regular procurement of standard goods and services** and services by using the mechanism of auction and tender - i.e. purchasing goods and services whose quality and quantity has been determined (they are the same, can be classified and standardized) and which price does not fluctuate considerably;
- **procurement of sophisticated/unique goods and services** by using tenders where the composition and cost of the purchase requires qualified evaluation of the need by the Supplier(-s), the price is high and depends on the complexity of fulfillment of the unique order, the procure-

ment requires special terms and conditions and preparation on the part of the customer.

Procurement Department

Procurement Department should base its purchasing activities on the strategy of the city development, proper evaluation of the existing status and long-term estimates of how the situation may change, i.e.:

- **they should have a clear vision of what must be achieved in a certain (e.g., five-year) horizon and what methods and trends are contemplated as the basic ones.** For instance, improvement of public health care by opening new facilities, employing sufficient number of competent staff, provision of materials and formulations, updating technical equipment of the medical facilities, introduction of an electronic record for visits;
- **fully understand the current situation (quality and quantity indicators).** For instance, know the number of medical facilities, condition of the premises, equipment wear and tear, cost of their maintenance and repairs, technological effectiveness, number of patients;
- **forecast changes that may be caused by external circumstances:** liquidation of medical facilities due to reconstruction and repair, equipment failures, increase or decrease of the number of patients (demographic forecast).

All that is required in order to ensure that even at the stage of planning and determination of needs the Procurement Department were able to assess the adequacy of plans and needs requested by institutions.

1. **Aim:** to ensure procurement of the goods and services required by the end user for meeting its KPIs, having optimal characteristics at optimal market price and taking into account the cost of ownership.

2. Objectives:

1. controlling the process at all stages, including external control by independent observers and public control authorities;
2. positive interaction between the customer and the supplier;
3. aggregating purchase volumes at the regional level for all regional customers and making up a list of suppliers who can provide everybody with everything:
 - search of new suppliers and evaluation of performance efficiency of long-term contracts;
 - evaluation of how well the supplier satisfies the user’s needs;
 - monitoring of each supplier’s status – monitoring of the risk associated with suppliers;
 - building relations with suppliers (providing for the suppliers’ meetings with the respective departments: briefing on the city strategic plans in a certain sphere which will need future procurement, suppliers’ information sharing on new technologies and opportunities, discussion of disputable issues).
4. Standardization (classification, category unification, description) of goods/services and contracts for regular purchases.

3. Subordination: a person in charge of ensuring the efficiency of the entities financed from state budgets in Moscow and efficient budget management.

4. Main directions:

- **administration of the state procurement process** (organization/control of performance and proper involvement of all participants and their due care), starting from the needs planning and justification up to the contract performance evaluation and the end user satisfaction, control and provision of efficient interaction among all participants (departments). Gathering proposals for improvement of the process and its development;
- **provision of timely competent expert examination at all stages**, from evaluating the need justification, its description in Requirements Specification and pricing to the proposal evaluation and acceptance of the

goods, services, both by using one’s own resources and employing third party assistance;

- **quality assessment** – end user satisfaction, keeping a database of honest customers and suppliers, evaluation of the customer’s planning efficiency, number of force majeure situations and their reasons;
- **cooperation with market players and effective operating control methods:** hot lines, opinion polls and analysis, prompt check of complaints, search and monitoring of suppliers, market research, new technology monitoring.

5. Procurement Department functions in the course of purchasing:

1. Stage: Procurement planning, needs identification and supplier pool definition

Customer’s Request Analysis

A collective body formed by the Procurement Department (end user, technical experts, financial expert, representative of the Procurement Department, representatives of the respective consumer and contractor communities) shall analyse the need justification, description quality and possibility of the need satisfaction.

The following questions are to be answered:

- is there a true need?
- is the need of the nature the customer describes (Will the purchase of the goods/services requested by the customer solve the existing problem? Has the customer considered long-term plans?)
May a different purchase or a different measure solve the problem? What product/service will meet the customer’s needs in the best way?
- is the need description sufficient for a potential contractor to offer a suitable proposal and understand what problem they have to solve in the course of procurement?
- the description should be checked for discriminatory indicators.
- are there funds in the budget to finance the purchase?

- Is it technically feasible to accept the product/service properly and start its use (adequate premises, personnel)?
- are the procurement dates stated properly? – Is it possible to deliver the goods/services in time with high quality? What stages of delivery are intended, who and in what way is involved in each of them, how are responsibilities divided?

Analysis of Suppliers and Procurement Conditions

The Procurement Department and the cross-functional group formed thereby identify a pool of suppliers, their technical capability of performing the order, price of service/goods and their operation costs, evaluate the operational efficiency (promptness of response to information requests) and appropriateness of response (they sent what was asked, quality), critical conditions of procurement (the supplier's requirements to the procurement conditions – the conditions which must be provided by the customer for the supplier to be able to fulfill the order properly). Gathering information from open sources, request for information from potential suppliers, meeting potential suppliers:

- which suppliers offer which goods/services in the respective segment, what are the suppliers' positions in the market and their clients? What are their pricing models and what parameters affect the price? Analysis of new technologies and new suppliers;
- comparison of similar goods/services from different manufacturers and suppliers with respect to technical parameters, length of service, warranty and maintenance;
- at what price can the product/service be purchased and what will the cost of further operation be?
- is the supplier actually in a position to deliver the requested product/service of the due quality, has the supplier previously supplied the respective products/services, has it got the necessary resources (own warehouses, transport, installation and maintenance personnel)?
- Suppliers have to confirm the quality of their goods/services: licenses, registration certificates, clinical tests, etc.;

- Has there been previous experience of cooperation with certain suppliers under state procurement contracts? What are the results? Which of them provided the required procurement volume and what are the customers' references?

Prequalification Organization

The thoroughness of suppliers due diligence depends on kind of the purchase. This factor also determines the Departments involved in pre-qualification process. The most scrupulous check is carried out for purchase of sophisticated/unique goods and services. In this case, the following persons are involved in pre-qualification:

Procurement Department invites the suppliers capable of supplying the goods/services of the requested quality to the prequalification for bidding, informs the Suppliers on requirements and procedures of bidding, asks the respective departments to conduct prequalification and checks that the process is organized according to the stipulated procedures and within stipulated time;

Tender committee – checking the documents;

Finance service – checking financial stability;

Security service – company legal status, management legitimacy and background, supplier's affiliation with the employees of the Customer or departments, their mutual affiliation.

The Procurement Department obtains the results of the prequalification and estimates the situation:

- Are there enough qualified suppliers?
- What changes in the needs description have been made in the course of the document checkup?

Results of the first stage:

1. the proper request which accurately describes the need and the procurement conditions and has no discriminatory elements;
2. the pool of qualified suppliers;
3. clear terms and conditions of procurement (stages, contract peculiarities – the obligations which the parties have to assume and be accountable for).

Further activities refer to the suppliers which meet the stipulated requirements.

2. Stage: Tendering and selection of supplier

In case of regular purchases of standard goods/services – electronic auction or a single-stage tender.

Procurement Department:

- participates in the formation of the committee including two or three qualified experts who are able to evaluate the content of the proposal;
- checks the conformity of the goods/services proposed by the supplier to the needs description and Requirements Specification;
- checks that all members of the committee obtain all the documents in time and peruse them;
- checks that all members of the committee take an active part in the process;
- checks that all members of the committee evaluate the request and the Requirements Specification according to the respective parameters (quality of goods/services, technical capability of fulfillment, supplier performance quality assurance, price, total cost of ownership), asks to submit comments in writing, if necessary.
- checks the conformity of the announced results to what is written in the request;
- apart from the price and name of the winning company, the goods/services are to be announced.

After the results are announced and within seven days until the contract is signed, the Procurement Department and the Public Control Authority accept claims of the tenderers and check their validity.

In case of purchasing unique/sophisticated equipment – tender with two-level evaluation of proposals by a special committee (technical assessment, cost of ownership assessment).

Procurement Department (in addition to the above-mentioned functions):

- participates in the formation of the committee having a technical expert group and a financial group;
- organizes proposal evaluation: first, the technical expert group ranks the proposals, then the proposals selected by the technical ex-

pert group are used by the financial group to choose the most appealing ones from the point of view of economic efficiency. The short-listed proposals are collectively examined by the committee (both groups simultaneously) and the winner is determined.

The result of the second stage:

the qualified supplier capable of performing the state order.

3. Stage: Contract closing

Regularly procured standard goods/services

In case of standard goods/services, it is recommended to develop standard contract forms for each area of procurement (pharmaceuticals, furniture for children's education institutions etc.). To take into account the specific properties of the area, business community representatives – potential suppliers are engaged in the process.

Procurement Department controls closing of standard contracts in due time.

Procurement of unique/sophisticated equipment

Although at the first stage the contract terms and procurement stages have been discussed, at the stage of contract closing the Procurement Department and the collective body (customer's representatives, financial experts, lawyers, technical experts) should coordinate and approve the contract.

On the whole, direct procurement is promoted by:

1. Lowering the supplier's financial risks: using pre-payment instead of payment upon delivery or providing guarantee of a reliable state-owned bank of the customer's obligations fulfillment.
2. Increased customer liability for default – possibility of suspending the state contract in case of the customer's default, possibility of claiming reimbursement for the losses incurred by such default, penalties for breach of counter-obligations and violation of the contract performance.

The contract has to balance and stipulate the following:

- expressly stated customer's obligations and penalties for their breach in the course of procurement;
- provision of the technical information required by the contractor for the equipment delivery and installation;
- the customer has to make ready the site/premises in accordance with the respective requirements stipulated by the manufacturer and legislator;
- the performance process has to be clearly specified at each stage: strict definition of the stages and their sequence, responsibility of the parties for execution of individual stages, in particular, on the part of the customer, timely provision of access documents, safekeeping of the delivered equipment during its installation, timely provision of quality consumable materials, if those have not been included in the initial order;
- payment dates, possibility of pre-payment if the delivery and installation are spaced in time, time-phased payment (payment for delivery and payment for installation);
- the supplier's financial liability limitation – maximum liability = contract value;
- description (regulation) of the procedure used for checking the quality of products during procurement.

Annexes to the contract:

- standard document – the claim with respect to product quality/quantity;

- in the contract specification the unit price of the product must match the value which the customer used when calculating the starting maximum price of the contract/lot.

The result of the third stage: the contract protecting the supplier and the customer and providing the basis for the procurement.

4. Stage: Follow up activities and control of the supplier satisfaction

On the 4th stage Procurement Department has to control the fulfillment of obligations both from the formal point of view (the contract is signed, then the work starts, timely deliveries) and the technical one (if required).

Procurement Department taking part in the committee organized for acceptance of goods/services.

Procurement Department controls of proper (actual rather than formal) acceptance of the procured goods/services by the collective body and, if necessary, testing the procured goods/services. Procurement Department provides end user satisfaction assessment.

Procurement Department evaluates of how the procurement affected the customer's core activities (request for information and its analysis).

APPROACH TO APPLICATION

Work of Procurement Department

Direct procurement	Regular procurement	Procurement of unique inventories/services
Procurement Department		
<ol style="list-style-type: none"> 1. Control over grounds: there is need and urgency. 2. Quick notification of suppliers 3. Prequalification launch. 4. Acceptance, registration and transmission of offers to the customer. 5. Selection assessment: terms-quality-price. 6. Formality check: contract concluded prior to/after works start, payment as per contract, works start and completion, user satisfaction questionnaire. 7. Assessment: frequency of urgencies, emergence of similar need, selection of a single supplier. 	<ol style="list-style-type: none"> 1. Classification and standardization of inventories and services. 2. Control over justification of need, specification thereof. 3. Participation at the Requirements Specification development, engagement of specialists as may be necessary. 4. Invitation of maximum numbers of suppliers. 5. Pre-qualification launch and participation thereat. 6. Analysis of offers, including the Technical Component – engagement of internal and external resources in offers assessment. 7. Organization of commission, control over its work, ensuring expert assessment in the commission. 8. Operative work with participants' complaints (check). 9. Participation at contract coordination, organization of quality control at supply, assessment of execution and satisfaction. 	<ol style="list-style-type: none"> 1. Interaction with the customer and engagement of external experts for purposes of defining needs, Requirements Specification. 2. Invitation to suppliers and pre-qualification launch. 3. Assessment of the supplier's possibility to perform contract and discussion of contract and supply conditions (stages, procurement, payment, supply conditions, liability of the parties). 4. Organization of two-stage tender commission: technical and financial assessment of offers. 5. Work with participants' complaints. 6. Control over ensuring supply conditions and stages by the customer. 7. Control over contract performance by the supplier – the formal part, and quality control at supply (including invited experts). 8. Execution and satisfaction assessment.

APPROACH TO APPLICATION

Work of Procurement Department

Direct procurement	Regular procurement	Procurement of unique inventories/services
Suppliers' prequalification		
<p>Procurement Department:</p> <p>1. Automated procurement (the participant fills out the e-questionnaire):</p> <ul style="list-style-type: none"> – no listing in the Black List; – registration, licences; – at least 3 years of experience; – personnel: numbers, qualification, quality management systems and training; – logistics: procurement bases, laboratories, transport. <p>Other departments:</p> <p>2. Security service</p> <ul style="list-style-type: none"> – on founders and management; – charters, lease agreements; – affiliation with employees, with other suppliers. <p>Double-check on the Internet, Spark.</p>	<p>Procurement Department:</p> <p>1. Automated check.</p> <p>2. Competence check:</p> <ul style="list-style-type: none"> – Of technical abilities; – Competence of participant. Taking into account the users' feedback on work with the supplier (collection of information on experience). <p>Other departments:</p> <p>3. Security service.</p> <p>4. Financial service check of the supplier's financial stability:</p> <ul style="list-style-type: none"> – Financial reporting; – Balance sheet; – Forms 1 and 2; – VAT documents. 	<p>Procurement Department:</p> <p>1. Automated check.</p> <p>2. Competence check.</p> <p>Other departments:</p> <p>3. Security service and/or outsourcing to specialist organization.</p> <p>4. Financial service.</p> <p>5. Internal control service:</p> <p>Possibility and mechanisms of participants' actions in bad faith.</p>



POSITION OF THE COMMITTEE FOR PROMOTING COMPETITION, RUSSIAN UNION OF INDUSTRIALISTS AND ENTREPRENEURS, ON THE DRAFT LAW ON FEDERAL CONTRACTUAL SYSTEM IN PROCUREMENT OF GOODS, WORK AND SERVICES

The Committee for Promoting Competition of the Russian Union of Industrialists and Entrepreneurs (RUIE) has examined the Draft Federal Law On Federal Contract System in Procurement of Goods, Work and Services (hereinafter the Draft Law) to be submitted to the State Duma (Russian Federation Government Decree of May 4, 2012 No. 712-p).

On the whole, the Draft Law On Federal Contract System in Procurement of Goods, Work and Services (hereinafter the FCS) introduces a proper and highly needed structure of organizing procurement for the state and municipal needs (procurement planning, order placement, contract performance, control over all procurement stages). The indisputable advantages of the Draft Law include the following: its comprehensive approach, coordination of all stages of procurement, introduction of the procurement planning, control over contract performance and the notion of civic watch over the entire FCS functioning. The RUIE Committee for Promoting Competition supports the concept of the Draft Law and most of its provisions.

At the same time, the Draft Law has a number of significant drawbacks calling for its substantial amendment. A lot of references to subordinate legislation which must be adopted in order to implement the new law and whose absence will prevent the FCS from functioning, absence of comprehensive regulatory support of all parts of the contract system – these shortcomings may negatively affect the work of business entities in the course of transition to the federal contractual system. Besides, the Draft Law is in contradiction with more than 40 statutory instruments currently in force.

Failing to resolve many of the existing problems of placement of orders for products, work, and services supply for the state and municipal needs, the Draft Law introduces a number of new mechanisms and provisions lacking final

and thoroughly elaborated version which increase corruption risks. Other factors worth mentioning include the lack of proper controls over customers, absence of contractual service (contract manager), of liability procedures as well as the lack of a real mechanism of restoration of violated rights of the procurement participants.

We cannot agree to the decision to cease using the well-established uniform portal zakupki.gov.ru by the new purchasing system. Instead of the effective system of the uniform portal integrated with five carefully selected electronic platforms, the Draft Law suggests creation of a new uniform information system and selection of new electronic platforms, which will result in substantial extra spending of budget funds. The Draft Law does not stipulate any provision to restrict the number of platforms. As a consequence, information security, monitoring and reliable control over the platform operation may be at risk. Cost of electronic auctions will increase (the fewer participants use the platform, the higher is the fee for participation in auctions).

Introduction of the new Draft Law will cause obligatory retraining of a huge number of procurement participants, which amounts to 210,000 customers, and over 70,000 employees of customers and entrepreneurs. That is going to lead to new expenditures on the part of the government and business. The arguments in favour of replacement of the current Internet portal by a new one seem to be rather weak, as the existing electronic auction system, according to all available estimates, did not incur substantial budget expenditures for its creation and even allowed to save over 300 billion budget rubles in 2011 alone.

According to our analysis, the Draft Law has to be amended along the following lines:

1. Lack of transparency of the proposed procurement procedures. Introduction of

new methods of purchasing (limited participation tender, request for quotations, request for proposals) which are fraught with corruption risks.

2. Inefficient system of liability for violation of procurement rules within the framework of FCS which is caused by highly bureaucratic methods of control/supervision on the part of the public authorities and vague delimitation of the respective regulating functions, including their levels (federal, regional, municipal).

3. No mechanism of timely restoration of violated rights of the procurement participants.

4. Imperfect legal methodology, including introduction of novel terms, definitions of terminology, poor wording of many provisions.

To remedy the said shortcomings, the Committee has formulated the following specific proposals:

1. Method of purchasing. Lack of transparency of the proposed procurement procedures. Introduction of new methods (limited participation tender, request for quotations, request for proposals) fraught with corruption risks (Draft Law, Article 24).

1.1. We suggest limiting the methods of purchasing by the following:

- 1) open electronic auction;
- 2) open tender;
- 3) two-stage tender;
- 4) closed auction;
- 5) closed tender;
- 6) closed two-stage tender.

1.2. It is necessary to exclude such method as "limited participation tender" (Draft Law, Article 50). We consider this method of prequalification selection by the customer to be non-transparent. Instead, to avoid failure of the public contract, we suggest that the participants of the other procurement methods described above shall submit documents confirming fulfillment of a similar contract of the value which is at least 20% of the order being placed.

1.3. The Committee suggests replacing "request for quotations" by short electronic auction.

1.4. The Committee suggests excluding from procurement procedures the method called "request for proposals" as it is fraught with high corruption risks because:

1) there are other instruments to solve the problems stipulated by the Draft Law as the ones requiring this method of procurement. For example, "request for proposals" is envisaged in the following cases:

- a) to meet the needs which have been caused by force majeure circumstances. We recommend using a short auction in those cases.
- b) if in Q4 of the current financial year a procurement need arises thanks to the increase of budgetary provisions for the current state or municipal needs. *In any case the customer can wait for the fourth quarter and place its order with the "sought for" supplier;*
- c) if previous purchasing procedures are recognized to be void under the current Federal Law and the customer comes to the reasonable conclusion that a repeat procedure is not expedient due to the urgency of the procurement. We believe that *the right granted to the customer to substitute the method of placing its order is fraught with high corruption risk;*

2) Serious corruption risk of the above method of procurement is also contained in the provisions of part 11 and paragraph 1 part 13 Article 76, which give an additional reason to exclude the said procurement method in general.

Thus, part 11 of Article 76 stipulates that "in the case of establishing the fact of two or more submissions by one participant of the request for proposals, only the latest submission is accepted for examination, the other submissions are not examined and are returned to such participant". This provision is at variance with the principle of proposal examination applied in all other procurement methods: in the case of establishing the fact of two or more submissions by one participant of the procurement (auction or tender) for the same lot, unless the previous submissions by this participant are revoked, all sub-

missions of such participant for the same lot are excluded from examination and returned to such participant. Implementation of the new proposal enables manipulating with the price quotation in case of collusion with the customer.

Nor can the provisions of paragraph 1 Part 13 Article 76 be supported, namely:

13. "After announcement of the best proposal, the request for proposals is finished and all participants of the procedure of the request for proposals are suggested to submit, not later than the day following the date of the offer, the best and final offer with respect to all elements of their proposals". Implementation of this proposal gives the customer the possibility to give the contract to a "friend" supplier after all the proposals have been made public.

1.5. The Committee suggests excluding the proposed possibility to reject bids with dumping price allegedly considered to contradict the objective of efficient budget funds spending. To minimize the risk that customers can run when receiving dumping price offers, we offer the following wording of Article 36 of the Draft Law:

"Article 36 "Rejection of bids with dumping price offer».

1. "In submitting a bid containing the contract price offer which is twenty-five percent or more lower than the initial (maximum) contract price stated by the customer in its tender notice, the participant submitting such bid must include in this bid its obligation to provide security of the contract execution half as high as that stated in the procurement documentation".

1.6. The Committee considers that the procedure of choosing the procurement method must be stipulated by the law, with the customer representative not being given the right of such choice. Therefore, we suggest excluding paragraph 2 of Article 24 of the Draft Law according to which "the customer shall choose the method of identifying suppliers, contractors, providers according to the provision of this Section, while being obliged to take into account the terms of using the procure-

ment procedures stated herein and proceed from the necessity to ensure competition among the participants of the procurement procedures".

1.7. The Committee suggests that in case of force majeure circumstances the customer cannot be granted the right to cancel the procurement procedure after the tender envelopes have been opened.

The Russian Federation laws lack definition of force majeure circumstances. Therefore, we suggest excluding Part 2 of Article 35 from the Draft Law: "2. After opening of the "tender envelopes, after the final date of submitting bid for participation in the auction and before conclusion of the contract, the customer has the right to cancel the procurement procedure in case of force majeure circumstances".

1.8. The Committee believes that the existing provisions of the Federal Law No. 94 "On Procurement of Goods, Works and Services for State and Municipal Needs", regulating the procedures of such procurement methods as tender, auction and request for quotations, fully guarantee the transparency, fairness and lawfulness of their organization. Therefore, we suggest that the provisions of the Federal Law No. 94-FZ "On Procurement of Goods, Works and Services for State and Municipal Needs" be integrated in the respective sections of the Draft Law.

2. Inefficient system of liability for violation of procurement rules within the framework of FCS which is caused by highly bureaucratic methods of control/supervision on the part of the public authorities.

2.1. The Draft Law stipulates the customer's liability (Part 2 Article 11) but does not specify the liability for:

- failure to approve or late approval of schedules before the beginning of the financial year as well as failure to publicize or late publication of the schedules;
- late placement of the order, which is in some cases shorter than the manufacturing lead time for a given product. The customer's liability for deviation from the approved schedule should also be stipulated;

- establishment of unreasonable initial (maximum) price or failure to provide a reasonable initial (minimum) price.

2.2. The liability of government officials involved in the FCS should, in all cases of violation, be imposed by administration of punishment, including such forms of punishment as debarring from holding public offices for a period of two years and more and disqualification. We suggest graded forms of liability depending on the type of violation and taking into account mitigating or aggravating circumstances.

2.3. The Draft Law does not specify whether one or several authorized bodies will perform controlling and supervising functions in the sphere of FCS. Judging by the fact that the controlling and supervising functions are divided and regulated by different articles of the Draft Law, one can conclude that those functions are going to be vested in different public authorities.

That does not seem to be reasonable because of unnecessary duplication of functions. Besides, due to different levels of competence in the sphere of FCS, the authorized bodies will lack complete information required for carrying out planned/random checks of complaints made by the procurement participants or for inspecting procurement plans, schedules, requirements to rate setting, validity of the initial (minimum) price, etc.

3. Absence of a mechanism of timely restoration of violated rights of the procurement participants.

Nowadays a serious problem of the state and municipal procurement system is the lack of a mechanism of restoring violated rights of the procurement participants. The law does contain the necessary provision but it is not operational. Nor is the problem solved by the presented Draft Law. Therefore, the Committee suggests as follows:

- 1) there should be a possibility for the procurement participants to lodge appeals and have them examined by the antimonopoly bodies before the expiry of the time when the con-

tract is deemed to be concluded. To implement this provision it is necessary to actually forbid the customer to sign the contract within ten days from the date of placing the order or stipulate that "the contract shall be deemed to be concluded starting from the eleventh day after the date of posting to the uniform information system of the record testifying to the examination and evaluation of the requests to participate in the open tender, or, in the case of closed tender, from the date when the tender participants obtain such record; posting the auction record to the electronic platform; as well as seven days from the date of posting to the uniform information system of the record testifying to examination and evaluation of quotation requests".

- 2) At present there is no statutory differentiation of the results of complaint examination and recognition of its validity. It is necessary to introduce a provision under which, if the complaint is recognized to be valid and the violation can be remedied during the time of the complaint examination, the procurement results shall be subject to change and the procedure is not cancelled. In this case – depending on the nature of the violation committed by the customer – the procurement procedure shall return to the stage of evaluation and comparison and/or the contract shall be concluded with the entity whose application has been awarded the second rank (in tender procedures) or with the entity whose application has been the last but one according to its price quotation (in case of auction). Such measure will make the complaint procedure efficient and effective, since nowadays, even in case of serious violations neither "number two" nor other procurement participants bring their case before the court because the duration of court proceedings is too long to restore the violated rights even if having reasonable grounds for 'cancelling the procurement results.
- 3) It should be made possible to appeal to the antimonopoly body against actions of customers, customers' contractual services (contract managers) in the course of the contract performance.

- 4) Along with the possibility of administrative complaints, procurement participants should have the right of court appeals, provided appropriate amendments are made in the arbitration procedural legislation, with compulsory provision for short-term 10-day appeal.

In order to protect the contractual parties' interests in the case of non-fulfillment of the contract by its other party, it is recommended to stipulate the possibility of prompt termination of the contract both by the customer and the supplier (within 10 days) through the regulator. Upon termination, penalties should be imposed upon and damages claimed from the guilty party. This will be an additional mechanism for protection of customers from unscrupulous suppliers and protection of business entities from unscrupulous customers.

4. Imperfect legal methodology, including introduction of novel terms, definitions of terminology, poor wording of many provisions.

4.1. The Draft Law is only aimed at the effectiveness and efficiency of budget spending but it does not adequately focus on such an important principle of procurement as its **lawfulness**, i.e. law compliance of all procedures: planning, placement, execution of orders for the state and municipal needs.

Therefore, we suggest the following:

- 1) the notion "principle of lawfulness" should be added to Article 6 "Principles of Federal Contractual System" of the Draft Law.
- 2) Article "Principle of Lawfulness" should be introduced in the following wording: "*Lawfulness of purchasing for state and municipal needs shall be ensured by correct enforcement of the law and other statutory legal acts as well as by compliance of all customers, procurement participants, controlling and supervising bodies with the rules stipulated by the procurement legislation*".

4.2. The previous version of the Draft Law contained the terms "state needs" and "municipal

needs". We suggest retaining those terms putting them down as follows:

*"state needs shall mean goods, works, services required for **implementation of the government programmes** of the Russian Federation, federal target-oriented programmes, other documents of strategic and programme planning as well as for enabling government **customers to fulfill their public functions, tasks and powers and provide public services**, perform international obligations of the Russian Federation, including implementation of intergovernment target-oriented programmes where the Russian Federation participates, or for enabling municipal customers to fulfill their functions, tasks and powers as the subjects of the Russian Federation and provide public services and perform certain public powers transferred to the public bodies of the subjects of the Russian Federation under the federal laws for implementation of the government programmes of the subjects of the Russian Federation, of the regional target-oriented programmes, other documents of strategic and programme planning of the subjects of the Russian Federation;"*

"municipal needs shall mean goods, works and services required to enable municipal customers to fulfill municipal functions, tasks and powers, including implementation of municipal programmes".

4.2.2. "Federal needs" and "needs of the subjects of the Russian Federation" should be isolated from paragraph 3 Part 1 Article 3 as separate notions and their meaning defined.

4.2.3. Paragraph 2 Part 2 Article 17 should be worded as follows:

"Article 17. Plans for Procurement of Goods, Works and Services for State and Municipal Needs.

...

2. The Plan shall include the following information:

2) goals and objectives of the state body and local government body, name of the action of the Russian Federation government programme, target-oriented programme, plan or programme of development of the subjects of the Russian Federation and municipalities, other document of the programme planning adopted (approved) according to the stipulated procedure, name of the state or municipal service or function”.

4.3. Article 19 should be amended by excluding from paragraph 5 Part 1 the phrase “decisions (instructions) of the RF President” because decisions and instructions of the RF President are not statutory legal acts. According to Article 90 of the RF Constitution, President of the Russian Federation issues decrees and orders. The Committee believes it necessary to refer to the “President’s decision and instruction” as a separate cause of action.

4.4. A valuable advantage of the Draft Law is the introduction of a system of planning in the form of Consolidated Forecast of Procurement of a Goods, Works and Services which shall constitute an integral part of the RF long-term social and economic development forecast to be generated on the basis of ‘analysing procurement of the goods, works and services required for the state and municipal needs (Article 17) as well as Plans for Procurement of Goods, Works and Services for the State and Municipal Needs (to be developed for the three-year period, Article 18) and Time Schedule of Procurement of Goods, Works and Services for each financial year (Article 21).

Meanwhile, the Committee suggests introducing certain amendments in these Articles.

4.4.1. We suggest that Article 21 be amended to contain the provision of including in the time schedule both the initial (maximum) contract price and its justification and calculation rules. Paragraph 2 Part 3 Article 21 should be worded as follows:

“Article 21. Time Schedules of Procurement of

Goods, Works and Services for State and Municipal Needs.

...

3. Time Schedule shall include the following information:

2) contract terms and conditions including description of the items to be purchased (description of the procurement items according to Article 32 hereof), notably, the minimum requirements to the procurement item, quantity (scope) and scheduled dates (regularity) of purchasing goods, works or services, the initial (maximum) contract price, including its justification, calculation rules and the amount of security deposit (if applicable), payment stages (if the procurement, including contract performance, is to be done by stages);

4.5. since the provision of subparagraph c) paragraph 9 Part 1 Article 31 does not define the meaning of “managerial skill”, the requirement to take it into consideration implies corruption risks. The Committee suggests that this term should be either defined in such a way as to be adequately assessed or altogether excluded.

5. Other problems and suggestions.

5.1. Article 91 on monitoring the implementation of Procurement Plans and Time Schedules, should be amended to include checkup of the validity and justification of the initial (minimum) price. We suggest the following wording of Parts 3, 5 Article 91:

3. The points subject to monitoring shall be:

1) conformance of the expected outcome to the targets;

2) information on the spending of budgetary provisions stipulated by Plans and Time Schedules;

3) information on procurement, including the outcome of the contract performance;

4) information on the method of determination of initial (minimum) prices, including their justification and calculation rules.

4. Monitoring shall be carried out by reviewing customers' reports and information contained in the uniform information system and findings of inspections and audits, according to Articles 90-92 hereof.

5. Customers' reports shall include the following information:

1) the extent to which the state and municipal needs are satisfied by the procurement;

2) information on spending of budgetary funds appropriated for the procurement;

3) analysis of factors affecting the course and time of implementation of the Plans and Time Schedules;

4) any adjustments of the Plans and Time Schedules, stating the reasons of such adjustments;

5) information on the terms of identifying suppliers, contractors, providers and on the contract performance deadlines, as well as on violation of such terms and deadlines (indicating their reasons);

6) information on fulfillment or non-fulfillment of the contracts (indicating the reasons);

7) information on conformity of the procured goods, works or services to the stipulated requirements and information on the reasons for non-conformity of the functional and consumer attributes of the procured goods, works and services to the requirements stipulated by the contract;

8) information on the method of determination of initial (minimum) prices, including their justification and calculation rules;

9) other information according to the provisions of the Federal Law, other statutory legal acts.

5.2. We recommend introducing lists of sole suppliers, which must be open and available in the uniform information system. Any person is entitled to appeal against inclusion of sole suppliers in such lists by applying to the regulator.

5.3. It is necessary to put more emphasis on promoting purchases of environmentally safe and/or innovative goods, works and service by granting the most favoured customer status or introducing additional features as criteria for proposal evaluation.

5.4. The Committee believes it expedient to provide procurement participants with the right to familiarize with submissions of other participants (in particular, the winning and second-rank submissions) during public opening of envelopes in case of an open tender, or in the course of complaints procedure in other methods of procurement. Only the part of the submission which does not contain any commercial or other secrets protected by law (e.g., personnel files) shall be disclosed.

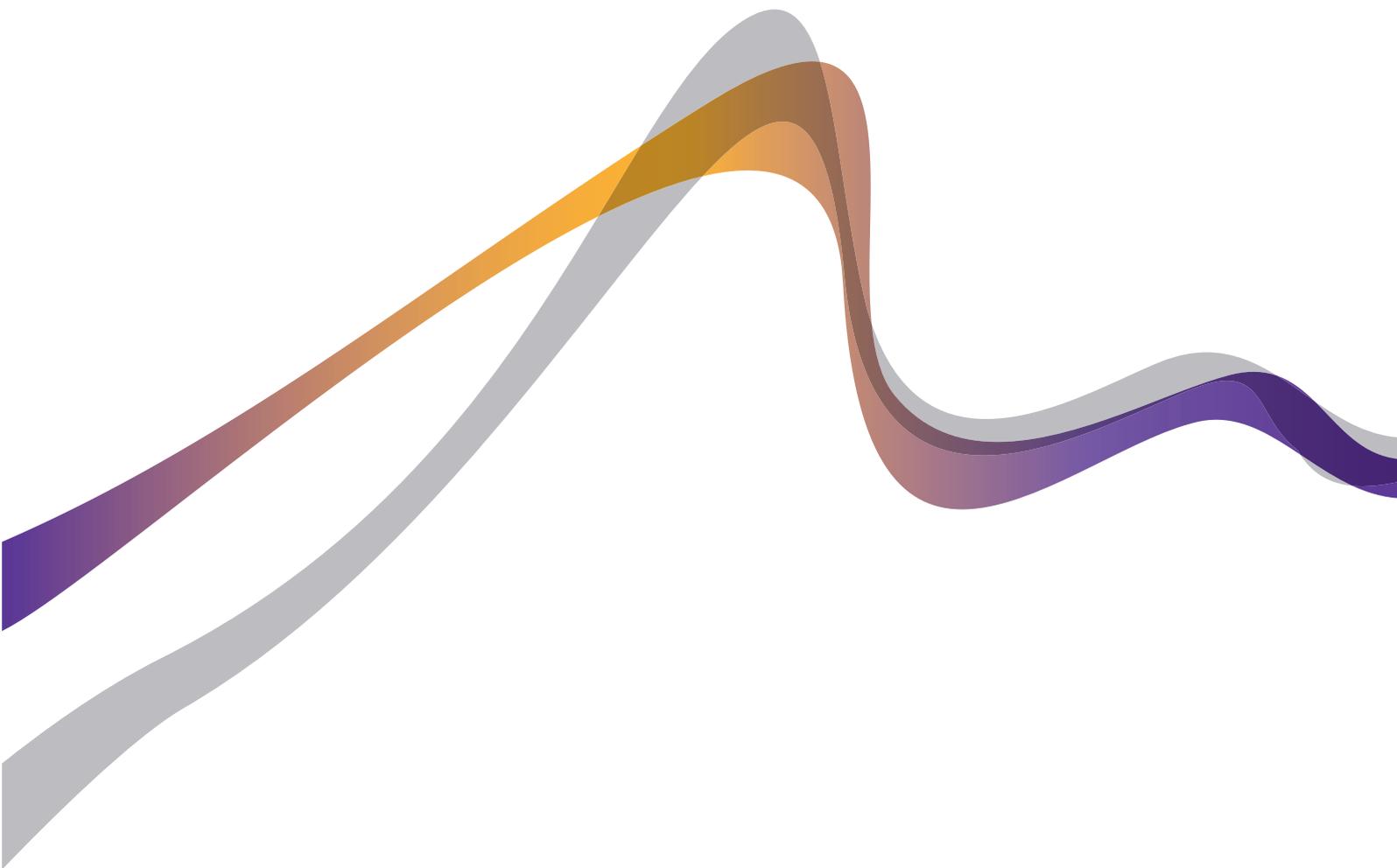
5.5. Nowadays, it is common practice for Rosoboronzakaz (Defence Procurement Agency) to carry out audits of military-industrial complex companies to check fulfillment of government contracts which have already been completed and formally accepted. In fact, the results of such audits enable the Defence Procurement Agency to revise contract prices because it often mentions inefficient spending of budget funds and prescribes to return "excessively paid" money to the budget.

In this regard, we suggest introducing a ban on the actions of customers, regulators and auditors intended to revise the prices stipulated by the contract and to recover money from suppliers/contractors.

5.6. In our view, the reasons for contract alteration stipulated in paragraph 1 Part 1 Article 87 "Contract Alteration and Termination" are inadmissible and must be excluded. This provision states that the contract can be altered in the course of its performance by agreement of

the parties if such option is stipulated in the procurement documentation and draft contract, and in particular: "1) in case of the contract price reduction without changing the quantity of goods, scope of work or services

and other terms and conditions of the contract"... In fact this will result in "arm twisting" of the supplier/contractor on the part of the customer without any economically grounded reasons.



BEST PRACTICES IN CORPORATE INTERNAL PROCUREMENT

SIEMENS: MUTUAL RESPECT FOR PRINCIPLES FORMS A RELIABLE BASE FOR LONG-TERM RELATIONS WITH SUPPLIERS

The aim of the procurement service is to ensure optimum price, quality and quick delivery in order to provide for efficient running of the company's core business. Hence, the procurement service must have a competitive base of suppliers meeting the requirements of the company, a transparent procurement process, and the best price offer in the market. Mutual respect for the principles and innovativeness are the main criteria used by Siemens in choosing its suppliers.

Siemens organizes procurement within the framework of the approved strategy of handling specific materials and it has its own supplier base.

However, operating in big markets, such as Russia, the company tends to revise the whole strategy. The procurement service examines which global suppliers and local players are present in the market. During the initial selection of potential suppliers we give preference to those who are interested in working with Siemens. Additional requirements to suppliers are established by the company compliance practice. In building its relations with suppliers Siemens always emphasizes that it has its own requirements and expectations, all suppliers have to undergo special audit which determines whether the supplier meets the environmental standards and principles of sustainability. The best suppliers are considered to be those who have supported the company for at least three to five years. Siemens is an innovative company and the supplier has to grow so as to keep pace with its development.

PROCUREMENT PROCESS

Planning

The corporate development plan for the period of five to six years determines the priority areas of its

business growth. It also contains the design of the required facilities, analysis of the products to be manufactured, groups of materials for their production. The list of those usually includes thousands of items. If an innovation appears, a special design team is formed which provides description of the new group of materials, thus ensuring production of the innovative product.

In the three-year horizon, the company identifies the suppliers who can provide it with the required materials and volume of supplies. First of all, the company focuses on the suppliers who have already cooperated with it. Unless a suitable supplier is found, a scouting process is launched.

Supplier Qualification

In scouting, first comes the market analysis. Here the company determines the competitive environment, the number of potential suppliers in the market, identifies those who have experience of collaboration with international companies, sufficient production capacities and specific knowledge required for manufacturing the materials needed by Siemens. Information is gathered from open sources, databases and exhibition materials. The market analysis yields about thirty potential suppliers who are then served letters of enquiry and interviewed by telephone in order to find out if they are interested in collaboration with Siemens and are able to deliver materials according to the specifications.

Scouting gives the possibility to check the supplier's reputation in the market, to get its registration address, to familiarize with its constituent documents and financial statements, to evaluate corruption risks and business standards.

After the first stage of scouting, fifteen to twenty potential suppliers are selected. They are invited

to special meetings where they are told about the specific features of the company and familiarize with design documentation, whereupon the preliminary assessment of their ability to produce components or materials in the required quantity is made.

Then a cross-functional group including engineers and production experts, logistics specialists, supplier relationship managers and security officers start visiting the suppliers, which takes two to three months, to evaluate their competence. Each expert holds an interview within the framework of the particular field of expertise. The group fills out the evaluation form including about 20 parameters: personnel management system, company mission, quality assurance system, production management, conformity of the production facilities to Siemens' technological requirements. The group formulates an opinion on the supplier competence, i.e. on its ability to produce the product or service Siemens needs. The scouting procedures result in choosing 10 to 15 suppliers which are considered by Siemens to be the supplier pool capable of producing the necessary materials and meeting the corporate requirements and business standards.

Scouting procedures (supplier audit) are carried out with respect to the heaviest industry categories, such as manufacturing accessories, units, components.

If the preliminary selection yields but one supplier matching the requirements of Siemens, we develop a plan of cooperation aimed at the supplier development. The scope of its facilities retooling is estimated which serves as a basis for the development of an investment programme stipulating what resources shall be contributed in the plant development by each party, what technologies will be transferred by the Siemens suppliers and within what period. The duration of the supplier development programme is from three to five years.

At the same time, Siemens enters into negotiations with global suppliers motivating them to work in the Russian market. In some cases, failing to promote development of a local supplier or attract a global company, Siemens makes decision to manufacture certain components on its own.

Suppliers of simpler materials and services undergo a series of tests enabling the Company to decide whether it is worthwhile to collaborate with the supplier. During this test session, potential suppliers complete a number of questionnaires, their credentials are verified in open sources, including Spark, besides which, the company asks for certain documents (balance sheet statement, constituent documents) and checks the supplier's track record of discharging obligations.

Procurement planning is based on identification of the needs. All company needs are divided into "regular" and "project" needs. "Regular" needs include those which are met by the company on a going basis, by purchasing a certain fixed list of materials. For example, one of the units produces transformers, and the procurement service regularly purchases materials for them according to a well-defined list containing 25 items. "Project" needs arise without any schedule, resulting from some unexpected events.

Each sector and each division determines what services they need for efficient work with their clients. On that basis and taking into consideration the market trends, they design their budgets. The procurement service, having received the information, works out its own plan and the capacity needed. Some specific materials or goods can be purchased by sectors directly, but all key materials and services supporting the core business of the company are procured centrally for all sectors and divisions. All company needs are classified: there are 16 categories, each having 320 item groups. Moreover, the procurement service is set the task of aggregating the volume at the regional level for all Russian regional companies, all Russian offices and make up a list of suppliers who will be able to deliver everything for everybody.

Needs Description and Preparation for Tenders

After the suppliers' qualification, the company holds a near term (1 – 3 years) tender. The period needed for the procurement is determined by the category complexity and market features. In case of purchasing motor cars, six months would be enough, translation services would need three months, while purchasing high-tech equipment might take a year or more.

The procurement service aggregates the needs according to projects in common lots, designs specifications coordinating them with technical experts, develops the tender strategy including selection criteria, procurement stages, assembly of the committee, and agrees it with the internal stakeholders.

After the strategy and specifications are approved, the procurement service provides the suppliers with the description of the needs, which is distributed by dates and delivery points at the regional level.

Tendering

Depending on the criticality of the material or service category to be procured for production, Siemens tendering strategy envisages division of the purchase amount among two or three suppliers. Typically, out of the pool of 10-15 suppliers only two or three suppliers are finally chosen, depending on the complexity and sophistication of the solution they offer. The minimum number of suppliers participating in the tender depends on the category importance and quality requirements. Of course, the fewer the suppliers, the easier they are managed, but a minimum mix of suppliers will not always guarantee the required value-to-money ratio.

At the stage of request for proposals from suppliers, Siemens informs them of the procurement model (how the company intends to distribute the purchase scope among suppliers) and of the method of tendering (how many stages are envisaged). If possible, the total lot is distributed among the suppliers according to the assortment groups; however, in this case the suppliers are notified that if delivery is failed in an assortment group, they are expected to be pre-

pared to interchange. Thus, Siemens achieves high transparency in its relations with suppliers and reserves an opportunity to choose the best one in each assortment group.

Siemens prefers to hold two-stage tenders. At the first stage, the procurement service asks for proposals and updates the market research findings, specifying what prices suppliers are ready to offer in each assortment group and category, determining maximum discount leverage, identifying the leaders and their terms and conditions of delivery (time terms, deferral of payment), their pricing model (when purchasing raw materials), and on the basis of this information determines the components of the price: what is the share of raw materials, transportation costs, overheads, the supplier's margin.

On the whole, at the first stage of the tender, the company identifies the main market trends. Upon completion of the first stage, the initial strategy in the given category is adjusted according to the updated information: e.g., the transport cost component may fall or new solutions may appear – all of this requires changes in the procurement strategy.

After the strategy has been adjusted, the tender committee composed of representatives of all functional divisions involved in the proposal assessment, holds a series of negotiations with potential suppliers. As a result, six of the previously invited 10-15 suppliers pass to the second stage of the tender. Different factors may serve as screening filters: delivery promptness, pricing model, etc.

Following the negotiations, the suppliers send new proposals (depending on the procurement complexity, proposals can be sent by email or by email with subsequent confirmation by official letter or even by a courier) which are to be recorded in a protocol and entered in the IT system.

As a matter of fact, the crucial factor considered at the second stage is the price, which refers to the total cost of ownership rather than to the mere price of goods or services.

At the second stage of the tender an electronic auction is organized which is used to determine the winner.

Should an additional need arise which is far in excess of the current amount of purchases, an additional tender is organized with new suppliers invited. The tender committee asks for prompt proposals and the supplier's quarterly statements to check the supplier's credibility. Also, representatives of the tender committee meet the top management of the suppliers to ensure transparency and quality of such urgent deliveries.

Contract

Siemens concludes a framework supply contract which additionally specifies the details of the procured category. Such an approach allows cutting transaction costs and reduces the load on the legal service. The specific features of the category determine the period for which Siemens concludes the contract and such features depend on the market factors.

Supplier Relationship Management

Siemens has adopted a process of supplier relationship management. Using this process, the procurement service evaluates the performance of the supplier in discharging its obligations, the quality of the products it delivers, the speed of delivery, the promptness and efficiency of response to the requests of internal customers and the pricing policy pursued by the supplier. On the basis of this analysis, the procurement service can even make a decision on the disqualification of a supplier. In such case the company starts looking for a new supplier.

However, the supplier relationship management is not only about evaluation of delivery quality provided by the suppliers. Siemens takes care to trace all changes relating to its suppliers: renovation of production facilities, change of the management team, customer base growth, development of the distribution network – all these factors are annually checked by random visits, telephone interviews, analysis of the information on the supplier's web

site or by asking the suppliers to complete questionnaires.

Keeping in touch with suppliers, the procurement services encourages them to expand their capacity for producing unique, customized products in order to reduce the amount of direct purchases at Siemens.

PROCUREMENT DEPARTMENT

The procurement service employs 26 people. The operation team supports the ERP system, logistics officers provide for deliveries and five people specialize in procurement (each one is in charge of certain categories of goods and materials). They are an experienced team, with each member having at least five years of practical experience, expertise in purchasing various categories and understanding of the category variability and nature: what market drivers cause price inflation, what are the fundamentals of the category management (distribution network, macroeconomic factors affecting prices, Siemens' purchase amount in the market, its influence, etc.).

Besides, Siemens possesses expertise background which helps Russian procurement officers to learn the history of each category, new technologies, level of competition, and pricing models used in China, Asia and elsewhere worldwide.

RISK MANAGEMENT AND CONTROL

Procurement is a neatly built process where each stage implies a number of carefully verified controls, key elements, which, when inspected by auditors, reveal and demonstrate the presence, regularity and criticality of violations.

In order to assess the "category health", one must regularly monitor such key issues as the number of years the company has collaborated with the supplier, the number of suppliers in a category, distribution and changes in the volume and assortment among suppliers and reasons for those changes. It is also important to look at the transaction component. Not only do auditors check documentation and correspondence, they communicate with suppliers, inter-

nal customers, peers of the procurement staff. The frequency of evaluation of the key issues and audits depends on the dynamics of procurement processes in the company and the procurement category; it can occur on a quarterly basis or annually.

To ensure transparency of the procurement process at all stages, the supplier relationship involves as many internal customers as possible, with each of them providing some information on the supplier. Besides,

the staff of the procurement department are obliged to store their correspondence with suppliers in special media. The staff are rotated on a regular basis: a person working with one category will work with another one after a certain period of time.

Therefore all described issues demonstrate an efficiently developed corporate internal procurement system that at the same time does not stand still but is being improved in the course of everyday activity.



TNK-BP HEALTHY COMPETITION ENSURES STABLE DEVELOPMENT OF PRODUCTS AND SERVICES MARKET FOR FUEL AND ENERGY INDUSTRY

Not only does the supplier's monopoly have a negative impact on the quality of supplied products and the customer's finances – it also affects other market players who are in fact robbed of choice. This is exactly why TNK-BP encourages competition in all the regions where we operate, gradually engaging more and more promising business partners as our suppliers. We believe that having three to seven independent contractors in a region creates healthy competition that guarantees long-term stability, with the suppliers' pricing policies being optimized by market mechanisms.

SUPPLY CHAIN STRUCTURE

TNK-BP began to change its procurement activities consistently back in 2005. As the first step of the reforms, the procurement service was transformed into a separate division. Today, the Upstream Supply Chain Management Division (Upstream SCM) includes an SCM unit in the Corporate Centre, SCM services in 10 operational subsidiaries and CJSC TNK-BP Supply, an independent company. All regional SCM units, along with CJSC TNK-BP Supply, report to Vice President, SCM, Upstream functionally, while subsidiary General Directors are their line managers. Upstream SCM employs more than 2,000 people.

Over the past few years Upstream SCM has improved its procurement system and supplier relations significantly. The key figures speak for themselves:

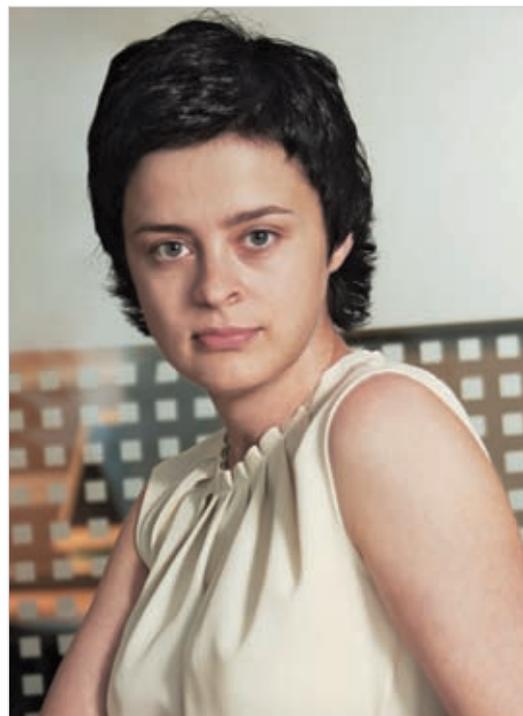
- 419 service types and 70,000 material types are purchased annually, which amounts to some \$7.5 billion;
- over 15,000 service contracts and material supply contracts are signed annually;
- long-term contracts account for 50% of material procurement contracts and over 40% of service contracts;
- materials and equipment delivery terms have become 2 to 3 times shorter than in 2005;
- percent defective is under 1.05% (2% in 2007).

Procurement Categorization

Upstream SCM procurement policy stipulates three lists of materials and services to be purchased. A service or material is included in one of the lists depending on its influence on the corporate operations, as well as the costs involved.

A list-based approach enables TNK-BP to delimit the procurement departments' responsibility areas easily and efficiently and implement procurement control in accordance with the Pareto principle.

TNK-BP employs category management methods for the purpose of strategic procurement management. This state-of-the-art approach to procurement is used by industry leaders and enables companies to make the most of consolidated procurement and uniform processes, on the one hand, and at the same time to treat different groups of materials and services separately. This approach assumes that each procurement category is, in its way, a separate business that requires a thorough supplier



Olga Malyshkina, Vice President, Supply Chain Management, Upstream

market analysis that helps to create the best scenario for interacting with that particular market. A category is a logical combination of cost objects united based on a certain criterion. While materials can be divided into categories based on the functional criterion, with services the situation is more complex. First of all, the procured services are grouped into “deal types” based on the following criteria: result of the work, pricing model and contractor market. Deal types are joined into “sectors”. A sector can cover various service types; however in any case the end result is a product of its own value for the company, such as a well, a geological field model or production growth.

Efficient category management is achieved through sector groups, i.e. cross-functional teams of professionals with technical and commercial competencies (meaning teams of SCM specialists). Their task is to develop and implement technology standards, pricing structures, contract templates and sector strategies. Each strategy implies reviewing the market, assessing the competition in the region, describing the relevant Russian and foreign experience and existing technologies. It also determines the approach to specifications and contract forms, describes the tools needed to manage suppliers’ prices and market shares, and records demand consolidation methods. Once technology and business objectives are achieved and the procurement becomes uninterrupted, sector groups transfer their sector management tools to functional departments and SCM.

Cross-functional teams with similar tasks also exist on the subsidiary level; however, the difference is that they focus on operational activities, that is, on using procurement management tools rather than developing them.

Category management has the following advantages:

- it helps avoid the situation where different functional teams purchase the same materials or services;
- consolidating the demand enables us to motivate suppliers with the amount of materials or services to be supplied;
- standardized procurement solutions improve the quality of materials and services provided;

- the buyers are experts in their category as they pay more attention to monitoring and analysing the market.

PROCUREMENT PRINCIPLES

Over the past seven years Upstream SCM has been improving its procurement activities continually, employing approaches that are new for the Russian market.

Long-Term Relations

Ever since 2005, Upstream SCM has consistently been building long-term relationships with partners. TNK-BP was the first Russian company to sign a long-term pipe supply contract with TMK, the second largest pipe manufacturer on the global market. Today the company has long-term relationships in such commodity groups as pipe products, submersible pumps, drilling, etc.

When TNK-BP offers its partners to sign a contract for several years, it guarantees certain stable volumes for a long period of time, so the suppliers can invest in innovations and business development. During the term of the agreement the contractors can count on technical support from TNK-BP experts who are interested in the contractors’ technological leadership, their product quality and constant attention to health, safety and environment standards.

Quality

Another important aspect of the joint activities is the improvement of production and innovation capabilities of TNK-BP’s partners and quality management with regard to the supplied products and services. SCM enables suppliers and contractors to improve their own technology level (through technical audits and corrective actions), as well as launch new products and consequently expand their markets. We strive to develop our contractors’ potential, encouraging them to improve product and service quality, achieve high production performance goals and apply innovative approaches.

We conduct technical audits throughout the world to make sure that suppliers and contractors comply with TNK-BP requirements and normative documents of the Russian Federation. More than 150 technical audits have already been completed. We maintain close contacts with our suppliers and contractors in order to eliminate the problems revealed by the audit findings. That results in a continual improvement of the contractors' quality assurance and control processes. We have gained a unique experience in organizing, and conducting audits as well as analysing the results. We share this experience and competencies with the companies within TNK-BP and external companies. Thus, in April 2012 SCM specialists held a training session called "Methodology and Execution of TNK-BP Technical Inspections and Quality Audits Related to Supplied Products and Documentation" for the managers and technical specialists of oil and gas equipment manufacturers and service providers.

We are now implementing a comprehensive approach to quality management throughout the order lifecycle, from design and manufacturing at the plants to logistics, incoming inspection and commissioning. The existing claim administration database features online tracking of the current percent defective data from our suppliers and manufacturers, making it possible to react to any deviations from contractual figures. Contracts for the supply of complex process equipment stipulate the continuous monitoring of suppliers' and sub-suppliers' product quality, as well as production lead time control and logistics control. The company has developed project quality control plans which imply working with suppliers on a regular basis. SCM specialists are responsible for acceptance of complex production equipment on-site.

Service providers are audited both during the pre-qualification process and before they proceed with their contractual obligations. If there are critical issues the contractor may be prohibited to proceed. Less critical issues are eliminated under an agreed schedule. Contractors put through the mill of TNK-BP improve their performance considerably in terms of manufacturing process and quality as well as health, safety and environment (HSE). For that reason the status of a TNK-BP contractor makes our partners more attractive for other customers as well.

The company's quality improvement activities have resulted in reduced percent defective, increased equipment MTBF, shorter lead times, world-level performance indicators achieved by a number of our contractors, etc.

MOTIVATION OF CONTRACTORS AND SUPPLIERS

The changing internal and external environment calls for developing new markets, looking for efficient partners and developing an import replacement programme. All those factors bring the supplier/customer relations to a new level characterized by incentives and motivation for mutually beneficial development as well as the contractors' organizational and technological growth. TNK-BP encourages its contractors to improve the quality, achieve high performance indicators and employ innovative technologies. TNK-BP has implemented a Contractor Performance Management (CPM) process.

CPM is a business process that includes establishing a mutually beneficial partner-like relationship between the company and its contractors in order to optimize costs while maintaining quality and throughput, as well as to stimulate a continuous innovation process (searching new solutions to existing challenges) and a system of financial and non-financial incentives for contractors. The CPM process focuses on the following areas:

- relationship management;
- contract administration;
- quality assurance;
- continuous development (innovations).

CPM makes contractual relationships more efficient and is beneficial for both TNK-BP and its contractors.

This kind of motivation gives the company the following undeniable advantages:

- it can be sure that the materials supplied and services provided meet the contractual requirements (you get what you paid for);
- there is less risk that substandard materials or services will affect the company's key financial performance indicators;
- the company can respond quickly to problems arising through initiating corrective action

plans, which makes it possible to avoid similar problems in the future;

- continual improvement of quality and efficiency, as well as incentives for innovation, enhances the company's business performance;
- reliable, unbiased and standardized data on contractor efficiency serve as the basis for analytic records needed for benchmarking the performance of several similar contractors during negotiations and the final selection process.

The advantages the CPM process gives our contractors are also evident:

- closer communication between the partners enables the contractor to understand the company's needs, requirements and expectations better;
- CPM includes a mechanism for early claim settlement / corrective action plan development, which helps to avoid the escalation of arising problems to the point where the customer may consider resorting to legal remedies and/or terminating the contract;
- an opportunity to receive additional profits through enhanced efficiency, including bonus plans;
- an opportunity for contractors that position themselves as industry leaders to prove their excellence through an unbiased efficiency assessment system, which can potentially bring a large number of orders both from the company and from other customers.

TNK-BP is introducing different motivational mechanisms into its procurement contracts. Depending on the situation in the industry sector, a contractor can be stimulated by additional orders or financial bonuses.

PRINCIPLES OF COOPERATION WITH CONTRACTORS

The key principle of TNK-BP procurement activities is an open relationship. The company creates the necessary conditions for an honest and open competition among the contractors and ensures that the selection process is unbiased and objective at all stages; that is why much attention is paid to making the selection process transparent and co-

operating with suppliers and contractors. Under its Corporate Standard on Procurement of Materials and Services, TNK-BP undertakes to manage its procurement activities, ensuring integrity and transparency based on the highest professional standards, while adhering to the relevant legislative norms.

TNK-BP is eager to establish open and simple relations with its partners. Meetings with suppliers and contractors are held regularly; in September 2010, Moscow hosted the first nationwide Supplier and Contractor Forum attended by some 300 representatives of current and potential TNK-BP partners.

In 2011, TNK-BP continued the practice of an open dialogue with the oil and gas materials and services market community. The second Supplier and Contractor Forum took place on September 15. In his welcoming speech German Khan, Executive Director of TNK-BP, said, "TNK-BP enhances the efficiency of its contracting system consistently, making it more transparent and constantly improving the partner feedback mechanism. We are building up reliable long-term contractor relations based on best international practices and strongly recommend to our partners that they observe business ethics standards established in TNK-BP. It is a key prerequisite for our mutually beneficial partnership, along with a guarantee of sustainable growth and prosperity for their business".

During the first Forum, regional Supplier and Contractor Interaction Councils were established; they included both TNK-BP specialists and the representatives of suppliers and contractors.

The key function of the Councils is to serve as forums for a direct dialogue between the company and its suppliers and contractors, to enhance contracting efficiency, explain cooperation principles and practices to contractors, identify and prevent violations of such principles and regulations.

In order to improve the system of cooperating with contractors and make the company's activities more transparent, Conflict Resolution Commissions have been created within the Councils. These are

intended to work with suppliers' complaints about the contracting process. Conflict Resolution Commissions are part of the TNK-BP anti-corruption programme. The Commissions consider all disputes between the company and its contractors, and sometimes our contractors' direct claims against

the company, and then make well-weighted and unbiased resolutions.

Judging by the regular polling of forum participants, the contractors believe that their interaction with TNK-BP is becoming more and more efficient.



IMPROVEMENT OF PUBLIC PROCUREMENT PROCEDURE

**RECOMMENDATIONS AND MATERIALS
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