

HOW DO YOU HANDLE RISING COSTS AND FLUCTUATING PRICES IN BIDS AND CONTRACTS, INCLUDING DISTRESSED SUPPLY CHAINS AND STAKEHOLDER CONCERNS ABOUT GOING TO MARKET?

Jonathan Davey, Partner,
Addleshaw Goddard LLP
LGA National Construction Conference 2023



MORE IMAGINATION MORE IMPACT



BREAKING DOWN THE QUESTION

- I will look at this question primarily from a procurement law perspective
- Philosophical question: whose problem is it?
- Handling rising costs:
 - Pre-award
 - Post- award
- Distressed supply chains and contractors in difficulty
- What have other countries done?
- Is there any help in the Procurement Bill?
- Some predictions

THE FUNDAMENTAL ISSUES

- As between contracting authorities and contractors, who should bear the risk of inflationary pressures?
 - Debate in HoL regarding the “inflationary spiral”:
“wholesalers are struggling to fulfil ...contracts due to unfavourable contractual terms, which are resulting in these businesses making significant losses...This is an unsustainable circumstance going forward.”
and this was said to be affecting the quality of what was being delivered
“We have to try to find a way for people to come together and think about how we can best handle that, and I think the current system does that well.” Does it?
- If the political decision is taken that allowing price adjustment would be desirable, is it possible within the constraints of the existing Regulations?
- Can one / should one differentiate between contracts on which the contractor is struggling and those where a decent profit margin has been eroded?
- Inequalities resulting from common mechanism vs divergent solutions: how accommodate?
- Does this cut both ways if input prices fall?
- Caution needed regarding use of non-objective/ non-independent indices?
- Must be a concern that SMEs/ VCSEs will be less resilient to losses

CASELAW: PRE-AWARD

- Danninger (Irish case) lawfulness of BAFO:
 - BAFOs sought; BAFO outcome changed winner when compared to ‘round one’
 - HELD: second round of tendering lawful, but need to mention in tender documents and equal treatment required
- Montpellier v Leeds City Council - abandonment:
 - LCC ran PSC in parallel to tender process; tenderers knew (1) tenders would be assessed against PSC, and (2) LCC might close the competition as a result

“LCC acted lawfully in deciding to abandon the tender exercise, having discovered that to award the contract on the basis of the advertised award criteria would not achieve value for money due to the level of public sector funding which it would need to make the project viable.”

 - Information provided sufficient, but:

“if the contracting authority delays informing the other party to the negotiations of its decision to abandon the procurement and has thus continued the pre-contract negotiations which it knew were bound to fail, that conduct could breach the principle of good faith and amount to the abuse of its right not to contract”

- so advisable to keep bidders informed
- Bottom line: keep options open, but ensure transparency
- See generally William Curry WP slide deck (bibliography)

CASELAW: POST-AWARD

- Conorzio Italian Management, Catania Multiservizi SpA v Rete Ferroviaria Italiana SpA :
 - Supplier sought increase in price; relief refused
 - In some cases, Italian law provides for the possibility of price review in certain contracts
 - Procurement law “do[es]... not impose any specific obligation... to lay down provisions requiring the contracting entity to grant its contractual partner an upwards review of the price after the contract has been awarded.”
 - “Similarly, the ... principle of equal treatment and the consequent obligation of transparency... do not preclude such rules either. On the contrary, it cannot be ruled out that a price review after the contract has been awarded may run counter to that principle and that obligation”
- So unsurprisingly no inherent right to increase

POST AWARD: CONTRACT CHANGE

- Generally, substantial contract change is treated as if a new contract had been awarded – usually unlawfully as there will have been no advert or process
- Reminder of when procurement rules permit change:
 - “*clear, precise and unequivocal*”; “*which may include price revision clauses*”
 - unforeseen circumstances: eg Ukraine war? But what about inflation generally? Timing issue...
 - Safe Harbour:
 - 10%/15% threshold more useful later in contract life; but
 - threshold cap renders this less helpful than it might otherwise be
 - Supplier insolvency and change of contractor: Reg 72(1):
“*universal or partial succession into the position of the initial contractor, following corporate restructuring, including takeover, merger, acquisition or insolvency*” so insolvency clearly covered
- Obviously, contract change generally requires consensus
- More detail in my PLA Handout: see bibliography

PROPOSED MODIFICATIONS TO PROCUREMENT BILL (1)

- Current circumstances were recognised by a proposed amendment to the Bill, schedule 8:

“7A(1) A modification is a permitted modification if—

(a) the average annual rate of inflation is 5% or more, and

(b) the modification prevents the supplier from being disproportionately affected by the inflation.

(2) In order to assess if a contract modification under this paragraph is desirable, contract reviews must be undertaken by both contracting parties every three months.”

- A number of issues with this approach:
 - upwards only
 - only covers suppliers who are disproportionately affected, ie not ‘average’ supplier
 - inflation will affect some contracts more than others, and some not at all
 - which inflation rate and over what “year”?
 - is the first 5% disregarded or not? And does one aggregate?
 - repeat operation of this clause?
 - retrospectivity?

PROPOSED MODIFICATIONS TO PROCUREMENT BILL (2)

- Proposed amendment ditched from the Bill (see Hansard (reference in bibliography)); reasons:
 - it could be misinterpreted or even open to abuse
 - term “*disproportionately affected*” imprecise
 - “*contracting authorities should not be automatically expected to shoulder inflationary costs. Such costs would be borne ultimately by the taxpayer*”
- Observations:
 - reflects the fundamental issue outlined above
 - the first two reasons above could be overcome if the political desire were there!
- Proposals for:
 - 3-monthly contract reviews prompted by inflation (Amendment 370B): not clear how this would help, and amendment rejected on grounds of over-prescriptiveness and concern it would lead to inflation
 - termination right for FM with obligation to pay costs “*necessarily incurred in relation to the contract*” rejected: “*We would not want to mandate that a force majeure event always triggers an immediate right of termination or that contracting authorities must always bear the costs*”. Would Ukraine situation etc constitute FM?
- Will there be any impetus for reintroduction of such a provision in the Commons?

HOW HAVE OTHER STATES ADDRESSED THIS ISSUE? (1)

- Germany has taken a very different approach, reflecting a fundamentally different view as to the appropriate home for the impact of inflationary pressures
- Two sets of decrees (May 21 and March/June 22), the former general and the latter relating to Ukraine-related issues
- German law seems to legislate for the inclusion or non-inclusion of price escalation clauses: in general, prices are to be fixed
- The 2022 decrees modify these rules so as to require inclusion of price escalation clauses in future contracts, and to modify ongoing procurement procedures to include price escalation provisions
- As regards contracts in flight, Germany seems to take a radically different approach to English law (and, arguably, to the Directives):
 - Some existing regulations already allow the contractor to demand an adjustment to the contract or an extension of the execution time if the circumstances of the contract have changed and if it is “*unbearable*” for the contractor to be bound to the contract
 - The 2022 decrees contain the legal opinion that, by adjusting a contract to the changed circumstances, the contract is not substantially changed. Rather, the reason for the adjustment is considered to be restoration of the economic balance of the contract
 - Seems at odds with Directive and PCR wording (“*the modification changes the economic balance of the contract...in favour of the contractor in a manner which was not provided for in the initial contract*”)

HOW HAVE OTHER STATES ADDRESSED THIS ISSUE? (2)

- Ireland (May 2022): Irish Government introduced framework to apportion inflation costs in public works contracts:
 - employer may assume ex-gratia a share of up to 70% of inflation costs
 - application of the framework is limited to projects subject to the public work forms of contract
 - not mandatory and only covers costs incurred after 1 January 2022
- Guidance Notes on how the framework applies to:
 - the Public Works Contract for Minor Building or Civil Engineering Works Designed by the Employer (PW-CF5) and
 - the Public Works Short Form of Contract (PW-CF6).
- No detail as to how the framework interacts with public procurement rules, though possible need for expert procurement advice noted
- Further detail on the Irish Office of Government Procurement's Construction Procurement webpage: see bibliography

BUILDING PRICING MECHANISMS IN TO CONTRACTS

- Necessary, therefore, for contractors in UK contracts to seek express contractual provision for price increases
- Model Services Contract deals with indexation (see Schedule 15 Part C para 5):
 - contemplates certain amounts being subject to indexation
 - assumes CPI, but contemplates use of other indices
 - another alternative (Schedule 5(D)) contemplates a cap on supplier margin
- LGA's National Procurement Strategy for Local Government in England 2022:

“Increased costs due to high inflation, exponentially higher energy costs, the climate change emergency, disruptions in the supply chains and suppliers unable to meet contractual requirements, and the war in Ukraine are all material to the way in which councils approach procurement.

There is an imperative for the sector to share new approaches and to learn rapidly and openly with key partners including commercial partners. We must understand data and insights in order to develop innovative solutions to issues including price increases and potential market failure. The sector must work even more collaboratively and commercially. We must continuously improve our end-to-end contract management to fully realise the benefits from the contracts we have let”

- There is an analysis of different intensities of response to issues such as supplier failure from “minimum” to “innovator”, but no consideration of application of procurement law if (for example) an authority is actively managing supply chain risk

CONTRACTOR FAILURE

- See my White Paper Talk 2018: Financial models – *“Applying the lessons of Carillion How can we adjust financial evaluation models to protect clients at selection stage and award?”*
- Carillion, UK’s 6th largest supplier to public sector, issued profit warnings and entered liquidation
- Some large contracts awarded between profit warnings and liquidation
- House of Commons Constitutional Affairs Committee identified problem areas including an aggressive approach to risk transfer to the private sector and too great a focus on price: are we in danger of doing the same again?
- HC CAC:

“The Government must re-examine its due diligence procedures and learn from the Carillion crisis. The Government must develop a deeper understanding of its commercial partners’ supply chains and of the risks hidden behind their published accounts and public statements....Carillion’s balance sheet was fatally weakened by high risk construction contracts. It was also puffed up with high valuations of goodwill, reflecting no more than how much it had overpaid for acquisitions and which provided no security.”

- Current procurement regulations arguably prevent more thorough requirements and are overly backward-looking; any evidence that the Bill is addressing this?
- Include financial distress provisions in contract? Model Services Contract includes financial distress provisions (sch 18), extending to key sub-contractors and guarantors, which can ultimately result in termination, but...
- OGC Supplier Financial Appraisal Guidance (April 2008) still in place, but problematic vs PCR
- Ask for bank guarantees (but note cost); or PCGs (but not a complete answer)?

SOME SUGGESTIONS/ PREDICTIONS

- Authorities should reserve maximum flexibility in tender documentation (eg BAFO, abandonment) and consider greater use of negotiated approaches to preserve flexibility intra-process
- Shorter duration contracts; greater use of frameworks?
- Bidder pressure for price escalation provisions and (?) rights to terminate
- Pressure for something like the discarded inflation provision in the Procurement Bill?
 - notable that UK is out of step with some EU member states
 - better drafting could improve, but...
 - reflective of HMG view on where risk of cost increases should lie (cp Ireland and Germany)
 - blunt instrument, after the event
- Any index is open to challenge that it does not accurately map to 'real' rises in cost; partial alternative is focused price adjustment (but complex)

BIBLIOGRAPHY

- *Conorzio Italian Management, Catania Multiservizi SpA v Rete Ferroviaria Italiana SpA (C-152/17)*
 - *Danninger v Bus Atha Cliath [2007] IEHC 29*
 - *Montpellier Estates Ltd v Leeds City Council [2013] EWHC 166 (QB)*
 - *Hansard re Procurement Bill*: [https://hansard.parliament.uk/lords/2022-10-26/debates/58B9F428-CCBF-490D-8A5A-6895E6002F73/ProcurementBill\(HL\)](https://hansard.parliament.uk/lords/2022-10-26/debates/58B9F428-CCBF-490D-8A5A-6895E6002F73/ProcurementBill(HL))
 - *Irish Government webpage*; <https://constructionprocurement.gov.ie/inflation-co-operation-framework/>
- “What mechanisms can mitigate the risk of rising costs and fluctuating prices, including energy and stakeholder concerns about going to market?” – [William Curry, White Paper] September 2022
- Jonathan Davey: PLA presentation on Contract Change and the Procurement Bill*: <https://www.procurementlawyers.org.uk/2022/06/27/pla-event-slides-procurement-bill-first-impressions-22-june-2022/>
- Jonathan Davey: White Paper talk 2018: Financial models - Applying the lessons of Carillion :how can we adjust financial evaluation models to protect clients at selection stage and award?*

Articles of interest

- “Procurement in an inflationary market: Public sector professionals must lead the charge” – August 2021
- “How to deal with price increases in this inflationary market” – January 2022
- “Full-potential procurement: Lessons amid inflation and volatility” – April 2022
- “How procurement can drive savings in a world of high inflation” – April 2022
- “Construction contracts: drafting for price inflation” – May 2022
- “Seeking certainty at an uncertain time – mitigating the risks of supply chain disruption in construction contracts” - October 2022
- “Dealing with supply cost volatility on major projects: The use of price escalation clauses in construction contracts” – October 2022

HOW DO YOU HANDLE RISING COSTS AND FLUCTUATING PRICES IN BIDS AND CONTRACTS, INCLUDING DISTRESSED SUPPLY CHAINS AND STAKEHOLDER CONCERNS ABOUT GOING TO MARKET?

Jonathan Davey, Partner,
Addleshaw Goddard LLP
National Construction Conference 2023



MORE IMAGINATION **MORE IMPACT**

