

HOW HAS THE JAMES WASTE CASE CHANGED EXISTING THINKING ON THE GATEWAYS TO MODIFICATION UNDER REG 72(1), AND HOW DO YOU ADVISE YOUR CLIENTS?

A NICE LITTLE EARNER!

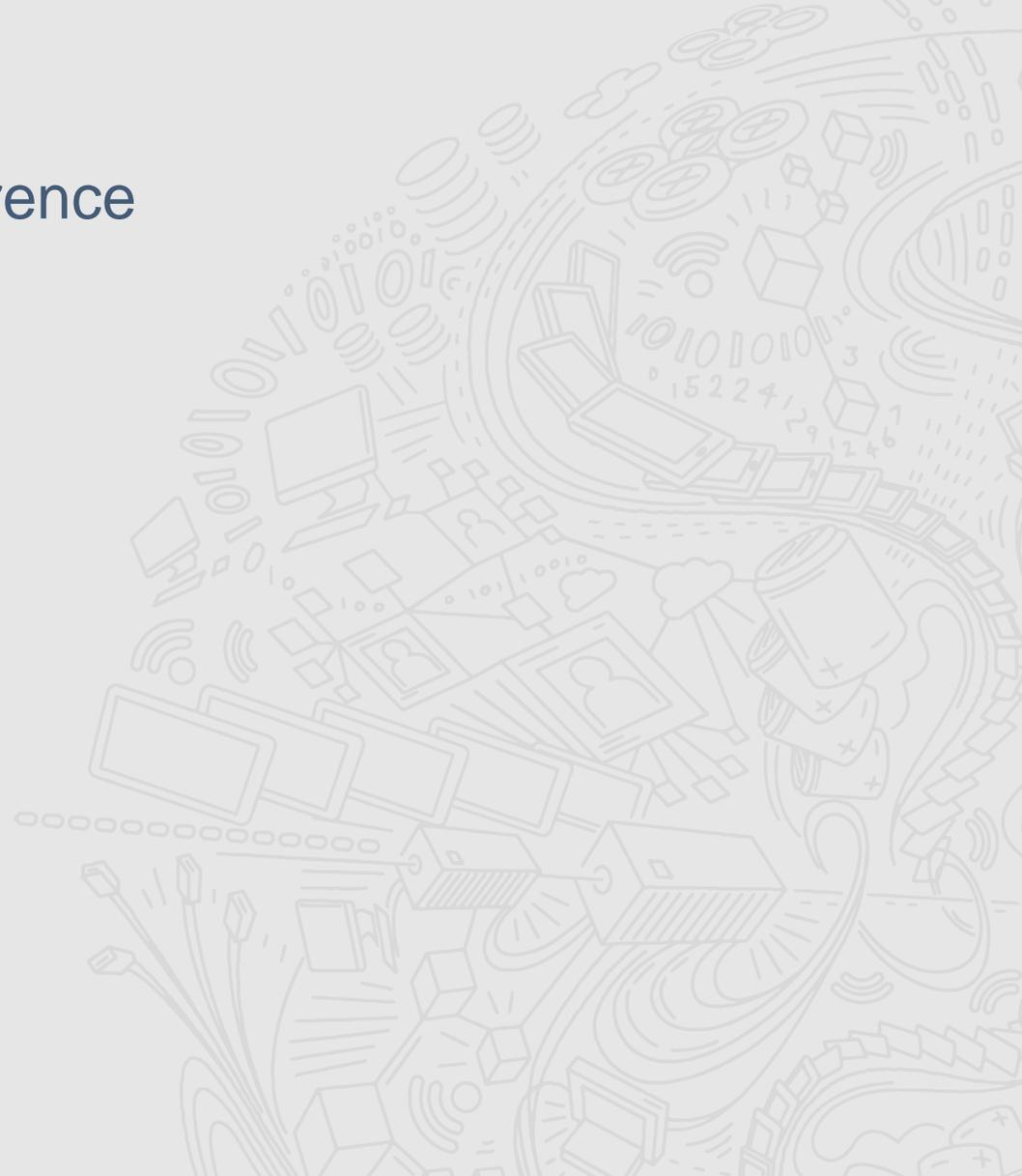
The White Paper Procurement Conference

17 November 2023

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WHAT WE WILL COVER TODAY

- Importance of this issue vs dearth of clear authority
- Brief reminder of relevant elements of Regulation 72 (or Section 74 and Schedule 8)
- Recap of relevant case law: Edenred, Gottlieb, James Waste, with focus on issue of EB
- Analysis of the possible alternative approaches to issue of EB
- My argument: that the case law is unclear and confused, and we need clarity and rigorous approach
- Does the Procurement Act help? (No!)
- Towards a clearer approach
- Bibliography below, and paper in conference materials

REMINDER OF RELEVANT ELEMENTS OF REGULATION 72 (OR SECTION 74 AND SCHEDULE 8)

- Presstext: "*An amendment may also be regarded as being material when it changes the economic balance of the contract in favour of the contractor in a manner which was not provided for in the terms of the initial contract.*"
- Presstext uses the language of materiality, rather than substantiality as used in the PCR; Classic Directive uses both!
- This dictum is reflected in Regulation 72(8) as one limb of the substantiality test, as follows:

"the modification changes the economic balance of the contract or the framework agreement in favour of the contractor in a manner which was not provided for in the initial contract or framework agreement"
- Accordingly, it is pivotal to know what is meant by a change in EB. In particular, where a contract change involves more consideration for the contractor, less output for the same remuneration and/or payments based on a modified payment mechanism, is this ipso facto a change in EB or is more required in order for there to be a substantial change?

DIFFERENT SCENARIOS

- At least the following:
 - additional w,s,s identical to those already provided under the contract are to be procured, to be supplied at the rates specified in the contract (Scenario 1);
 - provision of w,s,s different from those which are already provided under the contract are to be procured at a price specific to those items (Scenario 2);
 - a change to the scope or quantity of w,s,s to be provided under the contract, either with or without an adjustment to price (Scenario 3);
 - a change in the contract rate without provision of any additional w, s, s, perhaps to reflect inflation (Scenario 4);or a combination of the above.
- The situation in James Waste was a combination of Scenarios 2 and 3
- Scenario 1 is likely to be the easiest to analyse;
- Scenario 2, and Scenario 3 with a change in price, are likely to be the hardest.
- The above omits changes which are not economic in character (eg extension without more)

WHAT, THEN, IS A CHANGE IN ECONOMIC BALANCE?

- Cannot sensibly refer simply to a situation in which no additional consideration changes hands, because;
 - an increase in price is clearly contemplated by other provisions of Reg 72;
 - if that had been what the Community legislature had intended it could have been dealt with much more simply than by including the somewhat Delphic concept of a change in economic balance
- Does contract modification need to involve more profitable work or work at rates higher than those available in the market either at signing or at the point of modification for EB to change? No, for example, a reduction in liability limits or LDs , or removal of unprofitable activities, could all change EB
- Contracts involving initial capital outlay or investment: mere straight line pricing re additional w,s,s will result in a windfall to the contractor
- Modifications involving an extension / reduction of duration are now expressly called out in s74
- Unfortunately, caselaw inconsistent on this pivotal issue.

REVIEW OF RELEVANT CASE LAW: EDENRED (HC)

- Claimant sought, late in the day, to advance financial evidence based on confusion between margin and profit, leading court to say:

"Edenred's remaining arguments on the economic balance point were...fundamentally misconceived and...based on factual misapprehensions."

- Court nevertheless considered EB, observing:

"the (projected) profit margin shown in the baseline financial model for the Amendment Agreement is consistent with that in the...main contract." and

"The contractual charging mechanism remains the same under the Amendment Agreement as it is under the original Outsourcing Contract"

- Also, *"the [amended] services to be provided will be charged on the original basis, and not on some more advantageous "cost-plus" basis as alleged by Edenred"*

"Atos' profit margin is susceptible to...the same risks under the main Outsourcing Contract and the Amendment Agreement" and accordingly:

"Atos does not stand to gain any greater financial advantage from providing the [additional] supporting services under the proposed Amendment Agreement than it does under the main Outsourcing Contract."

- So relevant issues seem here to be profit margin or constancy of charging
6 mechanism or risk to profit or increased financial gain

REVIEW OF RELEVANT CASE LAW: GOTTLIEB

- Relevant dicta:

- *"the Development Agreement, as varied, is a more favourable arrangement than the Council would be likely to obtain in the market"*
- *"the unprofitable elements of the contract were largely removed, and the Developer gained a much improved opportunity to increase its return, and thus its profit."*

and the Court noted with seeming approval the following comment by one of the witnesses:

- *"even if the [percentage] return intended to be achieved by the Developer does not change ..., the actual profit that would be achieved would be significantly higher in absolute terms as a consequence of the changes."*
 - *Also, "The variations of the contract to remove the requirements to fund unprofitable civic amenities, if in place [when the original competition was conducted], would have provided an economic benefit to potential bidders beyond the original contract. In my view, they are material variations to the original terms which could not have been anticipated by potential bidders."*
- So, the above comprehends a comparison to current market terms, increased profit and increased profit percentage without choosing between them
 - Potential relevance of third party income streams

REVIEW OF RELEVANT CASE LAW: JAMES WASTE (1)

- Brief facts, common scenario: as noted, a combination of Scenarios 2 and 3
- No quibble with outcome (changes for last 5mm of 8yy contract)
- Court could have specified, having analysed dicta from Gottlieb and Edenred, which approach properly represented the key to change in EB, but failed to do so. By way of example, the court said:

"the change may be such that the original remunerative scheme cannot simply be applied to the services or supplies contemplated by the modification. That is in fact the case here in respect of the gate fees... In such cases, where a different payment mechanism has to be adopted, there is surely force in the suggestion made [in Arrowsmith] that "reasonable compensation" is the appropriate yardstick by which to judge a price increase." and

"There must surely be a consideration of whether the change is itself justified, and again, a useful yardstick would be reasonable compensation."

but this conflates two issues: the reason for the modification and the magnitude of the compensation. Reason for modification is surely irrelevant

JAMES WASTE (2)

- Court noted that "Veolia still earned less in the relevant period of the Modification than it had previously earned" but this is surely at best of marginal relevance to the EB question
- So, a new formulation: reasonable compensation; but this can't be correct; not clear Court had any evidence as to margin
- Judge noted:

"First [JW] says [ECC's evidence regarding reasonableness is of little or no value] because it does not go to a shift in economic balance. I disagree, because if the additional services are rewarded by reasonable compensation (and in circumstances where, as here, the original rate of remuneration cannot be directly applied) then there is no shift in the economic balance favourable to the contractor. Second, [JW] says that even if the rate was a reasonable one, that is not the end of the matter if one does not know Veolia's margin. But again, that seems to me to be of little, if any, significance if the agreed rate is itself reasonable compensation."

- This reasoning seems questionable: if EB pre-modification is based on rates which are uncommercial or unreasonable, how can additional w,s,s at reasonable or commercial rates not alter EB?

DOES THE PROCUREMENT ACT HELP?

- Generally, no!
- Strangely, given the almost universal change in language, the phrase “*economic balance*” is retained, though with “*materially*” added
- Maybe guidance will be forthcoming?
- Challenges may increase given the need for Contract Change Notices and publication of amended contracts (over £5M)
- Longer-term and complex contracts, as well as high rates of inflation in labour and raw materials rates likely to render this issue more significant and harder to resolve.
- Expert accountancy evidence should be sought and an economically-cogent view should be formed as to EB of the contract. And any change to it

POSSIBLE ALTERNATIVE APPROACHES TO ISSUE OF ECONOMIC BALANCE

- Is there a *de minimis* rule? See paper
- Reason for change should be considered irrelevant
- Reasonableness/ market rate also irrelevant
- Even with use of the same charging mechanism, a substantial increase to quantum of profit (even at same % rate) should be offside; may well infringe Reg 72(1)(a) (“*materially different in character*”) and (d) (“*extends the scope...considerably*”) anyway
- Double-edged problem with unprofitable contracts:
 - any non-*de minimis* profitability (or reduction in loss) may be offside; but
 - contractor unlikely to accept additional unprofitable work
- Arguably the changes in *James Waste* were not simply the increase in gate fee and mileage charge but the changes as a whole (- and the AG in *Presstext* said that the context of the change should form part of the analysis)

ANY QUESTIONS?

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