When is a variation caught by procurement law?

Hannah Kramer reports on a case that has highlighted the risk of a new public procurement exercise having to be carried out in the event of a 'material' variation to an agreement

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'The Silver Hill decision does not in itself establish any new principles, but reaffirms existing case law that public works contracts and concession contracts require a new procurement process in the event of "material" variations during the contract term.'

Winchester City Council has been suffering turbulent times recently following the High Court's recent decision on a judicial review application initiated by one of its own councillors (*R (Gottlieb) v Winchester City Council* [2015]).

The court held that the council had acted unlawfully in failing to adhere to procurement rules when deciding to vary the terms of a development agreement. The decision has understandably caused a stir among those directly involved, prompting the leader of the council to step down. It has also opened up an issue that has long been a concern to those who either have completed or are in the process of negotiating variations to development agreements with public authorities. No doubt the decision will cause contracting authorities and developers alike to adopt a more cautious approach when agreeing to vary existing development agreements and certainly they will require robust legal advice.

Although the case concerned the provisions of the Public Contracts Regulations 2006 (PCR 2006), which were relevant at the time, the judgment also underlines the principles contained in the newly implemented Reg 72 of the Public Contracts Regulations 2015, which sets out rules and procedures for the modification of contracts during their term.

The Silver Hill Development

In December 2004 Winchester City Council entered into a development agreement (DA) with Thornfield Properties (Winchester) Ltd for the comprehensive redevelopment of the Silver Hill area, by way of construction of a new mixed-use retail, residential, civic square and transport complex in the city centre. The relevant provisions of the DA were:

- The council was to assemble the land and the developer was to seek planning permission for the development and would be granted a new long lease of the site by the council.
- The developer was to deliver specified 'required elements' including, among others, a minimum of 90,000sq ft gross internal area of retail units, 35% affordable housing, construction of public parking spaces and the provision of a new bus station.
- The developer would receive the first 10% profit after taking account of agreed development costs, and would pay the council a fixed sum during the construction phase and, following lease completion, a geared rent (subject to a collar).

Case C-454/06 *Pressetext Nachrichtenagentur GmbH v Republik Österreich & ors* [2008] ECR I-4401

R (Gottlieb) v Winchester City Council [2015] EWHC 231 (Admin)

Case C-91/08 *Wall AG v Stadt Frankfurt & anor* [2010] ECR I-02815

- The DA provided for permitted variations to be made during the term of the project to the required elements, or to the layout of and materials used in the scheme, with the council's consent (such consent to be awarded in the council's absolute discretion).

The council did not carry out any procurement exercise before the DA was entered into – as is required by public sector procurement procedures. The development opportunity was not advertised in the *Official Journal of the European Union* and there was no competitive tendering process between potential developers. However, the DA required the developer to invite competitive tenders from at least three contractors for the works, and to sub-contract the residential aspect of the scheme with the council's consent.

Following the post-2008 economic downturn Thornfield went into administration and its business was acquired by Henderson Global Investors. The council made a compulsory purchase order in 2011 to facilitate the development and, following a public inquiry, the inspector recommended confirmation of the CPO and recorded the fact that Henderson had demonstrated they would be able to deliver the Silver Hill scheme comprehensively (rather than on a piecemeal basis) which was preferable to the council.

Variations

The DA was varied on a number of occasions between 2009 and 2014. In mid-2014 the developer sought the council's consent to a number of further changes (the 2014 variations), including the reduction of the number of residential units from 364 to 177, replacing the bus station with an on-street bus interchange, substituting the affordable housing requirement with a financial contribution of £1m (with the prospect of further clawback), inclusion of 60,000sq feet additional retail space, and reduction of the car parking requirements from 330 to 279.

The DA was also varied to allow the developer to procure construction of the whole scheme via a construction company with a housebuilding subsidiary, rather than sub-contract the residential element or require a competitive tender from three contractors.

To reflect the increased retail space in the scheme, the DA was varied so that the council would receive an increased annual sum during the construction phase, and an increased rental gearing percentage and collar under the new lease.

In August 2014, the council resolved to enter into such variations. Councillor Kim Gottlieb, a member of the 'Winchester Deserves Better' campaign, which opposed the scheme, applied for judicial review of the council's decision to permit these variations.

Application of the procurement regime

In 2004, when the DA was originally entered into, it fell within the scope of the procurement regime then in force (the Public Works Contracts Regulations 1991). This being the case, the council should have complied with the procurement rules before entering into the contract in 2004. However, this failure was now time-barred from challenge, and the question before the court was whether the 2014 variations were so substantial as to amount to a new contract and therefore require a new procurement exercise.

In 2014 the relevant procurement regulations in force were the PCR 2006. The court considered that the DA could be categorised as a 'public works concession contract', being a public works contract where the consideration to the developer consists of a right to exploit the works to be carried out. In this instance, the DA for Silver Hill provided for the developer to receive a majority share of the profits and be granted a lease of the site. There was no analysis by the court as to whether the DA amounted to a pure land transaction, which would not be subject to procurement rules.

The court also considered that Mr Gottlieb had standing to bring the claim. The PCR 2006 enables economic operators to challenge a public authority's decision and seek remedies such as an injunction against entering into a contract, a declaration of ineffectiveness of existing contracts, and/or damages. However, it does not preclude claims for judicial review by other parties. Mr Gottlieb, as a resident and council tax payer, had a legitimate interest in seeking to ensure that the council complied with the law.

Material variation

Unlike the newly implemented Reg 72 (see 'Public Contracts Regulations 2015' on p17), the PCR 2006 do not detail when an agreement may be modified without the need for a new procurement exercise. Instead, the court turned to case law on the subject and applied the principles laid down by the ECJ in the *Pressetext* case *(Pressetext Nachrichtenagentur GmbH v Republik Österreich* [2008]). Lang J held that all bar one of the 2014 variations amounted to a 'material variation', such that the council should have undertaken a new procurement process in 2014.

The key consideration for the court to determine was whether the 2014 variations affected the potential profitability of the development to the developer. In considering changes to the economic balance, regard should

What is a 'material' variation?

The *Pressetext* principle provides that a 'material' variation to public works contracts that triggers a fresh procurement process is one that changes the character of the original contract such as to demonstrate an intention between the parties to renegotiate the essential terms of the contract. The case provides the following illustrative examples which, in reaching its judgment in the Silver Hill case, the court considered should be broadly interpreted:

- new conditions which would have opened up the tendering process to other potential bidders had the conditions originally been included;
- extending the scope of the contract to cover services which were not originally covered; and
- changing the economic balance in favour of the contractor in a way which was not originally provided for.

be had to potential profits from third parties such as rental revenue, or profit from sale of the residential units that the developer may make.

The court held that by removing the unprofitable elements of the DA, the developer improved the potential profit it stood to make on the scheme. The fact that the council considered the varied contract to amount to a 'good deal' given market conditions in 2014, and agreed that the changes were necessary to save the project, was irrelevant. The council may have secured a 'better deal' for itself had it opened the contract up to other bidders.

The court focused on the following specific changes that it considered improved the economic position of the developer from the position under the original DA:

Bus station and additional retail space

Under the altered scheme, the developer no longer had to pay for the construction of a new bus station, and only needed to bear the reduced cost of providing bus stops and bays in the streets. More importantly, the space that would have been used by the non-profit-making bus station had been opened up by the 2014 variations for the construction of a new department store of just under 60,000sq ft. This increased retail space is likely to have added value to the scheme and would have significantly increased the value of the DA had it been included or been anticipated in 2004. The court dismissed the council's submission that this did not provide any additional benefit given the increased rent payable. Instead the court referred to the fact that Henderson had initiated the negotiations with the council to obtain the enlarged retail site as evidence that Henderson believed the change to be advantageous.

Affordable housing

The affordable housing contribution payable under the 2014 variations was considerably less than the commuted sum which would have been payable in respect of a 35% affordable housing element.

Civic amenities

The removal of unprofitable civic amenities, such as the new transport services and market street, would have provided economic benefit to potential bidders had they not been included in the original DA.

Developer procuring construction of the whole scheme

Removing the requirements to sub-contract the residential build and to invite competitive tenders for the development works gave the developer greater flexibility. This provided the developer with greater economic benefit than had been the case under the original DA.

Extension to long-stop date

The council was prepared to agree not to exercise its right to terminate before June 2015. Lang J did not consider this to be a variation of the DA – the council has the right in the contract to terminate after a specified date and was merely agreeing not to exercise such right before a later date. There was no evidence before the court that this provision was designed to circumvent the procurement regulations.

Identifiable alternative bidders

Lang J rejected the council's submission that the claimant had to identify other contractors who could have bid for the contract. She considered that the *Pressetext* principle applies to a 'realistic hypothetical bidder' and does not require a claimant to identify an actual potential alternative bidder. The court was satisfied that, on the balance of probabilities, other potential bidders with a realistic chance of success would have bid for the contract if they had been given the opportunity in 2004. The council had therefore acted unlawfully in resolving to agree the variations without adhering to the procurement regime.

Permitted variation clause

The council's submission that a procurement process was not required because the 2014 variations were contemplated by the 'permitted variations' clause in the DA was also dismissed.

Key points in the judgment

- Variations to public works contracts or concession contracts that are material such as to demonstrate the intention of the parties to renegotiate the essential terms of the contract (applying *Pressetext*) require a fresh procurement process.
- Contracting parties should not be able to circumvent the purpose of the procurement regime via a broad variations clause in the development agreement. If variations affect a 'decisive factor' in the contract award they may require a new procurement process – even if they were contemplated in the original contract.
- Variations required by planning or other public authorities, which amount to a 'material variation' under the *Pressetext* principle, may require a new procurement process.
- A claimant does not need to identify an actual alternative bidder, only a realistic hypothetical alternative, to demonstrate that a procurement process ought to have been followed.
- The court assessed how the 2014 variations affected the economic balance between the parties and therefore looked at how the changes, as a whole, affected the potential profitability of the development to the developer.
- The 2014 variations were considered against the original 2004 DA, and not against its amended form following the variations made between 2009 and 2014.
- In this case, each of the variations – removing affordable housing provision, increasing retail space available, reducing the civic square provision and removing the provision of a bus station – were material, increasing the potential profitability of the scheme to the developer and demonstrating the parties' intention to renegotiate the essential terms of the contract.
- Claims for judicial review can be brought by anyone with a legitimate interest in seeking to ensure that the contracting authority complies with procurement rules; ie, the ability to seek judicial review is not limited to economic operators.

Applying the ECJ's decision in *Wall AG v Stadt Frankfurt* [2010], the court considered that a fresh procurement process would be required if the variation goes to a 'decisive factor' in the contract award even if the particular variation was contemplated in the contract. The variations clause in the DA was too broad and unspecific to satisfy transparency requirements. The council had absolute discretion as to whether to accept a variation and there was no indication as to what changes may be accepted or on what basis. Hypothetical alternative bidders would not be able to anticipate what potential variations could be made. At best, they would know that variations could be applied for and that such variations may have an effect on rental income.

Interestingly, the court also suggested that a clause in the DA permitting variations pursuant to planning authority requirements cannot be used to avoid the need for a fresh procurement exercise if the variation was 'material' and satisfied the *Pressetext* principle.

Public Contracts Regulations 2015

Regulation 72 of the Public Contracts Regulations 2015 (PCR 2015) came into force on 26 February 2015 and codifies the current position as to which modifications to public works contracts will not trigger the requirement for a new procurement procedure. These are set out in the box on this page. The PCR 2015 will apply to modifications to contracts whose procurement started on or after the regulation implementation date. Contracts awarded before 26 February 2015, or which were advertised before this date and awarded afterwards, will continue to be assessed by the PCR 2006 and the *Pressetext* principle. The PCR 2015 broadly codify the existing principles as to permitted variations and should therefore be regarded when considering whether required contractual variations can 'slip under the radar' of the procurement regime.

What next?

The Silver Hill decision does not in itself establish any new principles, but reaffirms existing case law that public works contracts and concession contracts require a new procurement process in the event of 'material' variations during the contract term. The clear message from the courts is that contracting parties, and in particular contracting authorities, should take a cautious approach when considering any variations even where there is contractual provision for such changes to be made. Developers will not want to entertain the potential for a further procurement round during the term of the contract, or the possibility of the contract being awarded to another bidder, and contracting authorities will not want to open their decision-making process to the prospect of judicial review.

Though PCR 2015 Reg 72 helpfully sets out permitted modifications, contracting authorities are unlikely to agree to any variations without clear legal advice that they will not fall foul of the procurement rules, which may cause delay to developments promoted by public bodies. The court's decision that the parties cannot rely on a broad variations clause to 'side-step' the procurement regime may also lead to a more drawn-out initial tendering process. Contracting parties will want to cater for as many potential eventualities as possible when negotiating the contract terms. ■

Public Contracts Regulations 2015

Regulation 72 of the Public Contracts Regulations 2015 sets out the 'safe harbour' modifications to public works contracts which will not require compliance with a fresh procurement process:

- The modifications have clearly, precisely and unequivocally been provided for in the initial procurement document review clause. The precise nature and scope of the possible modifications must be set out as well as the conditions under which they may be used. There must not be any scope to alter the overall nature of the contract.
- For additional works, services or supplies by the original contractor, where a change of contractor either cannot be made for economic or technical reasons, or would cause significant inconvenience or substantial duplication of costs to the contracting authority. Any increase in price must not exceed 50% of the value of the original contract.
- The need for the modifications has been brought about by circumstances a diligent contracting authority could not have foreseen, and the modification does not alter the overall nature of the contract and does not increase the price by more than 50% of the original contract value.
- A new contract is entered into following a full or partial takeover of the original contracting party or pursuant to an unequivocal review clause, again provided that there are no substantial modifications to the contract and the new contract is not aimed at circumventing the procurement rules.
- The value of the modification is not substantial, ie does not:
  - materially change the character of the contract;
  - introduce conditions which would have allowed for other candidates to apply/be accepted if included in the original contract;
  - change the economic balance of the parties;
  - extend the scope of the contract; or
  - provide for the replacement of the contractor (other than in relation to a full or partial takeover as detailed above).
- The value of the modification is less than the relevant threshold for the specific contract, and below 10% of the initial value for service and supply contracts or below 15% of the initial value for works contracts.