Renegotiations of Public Contracts

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Renegotiations in Public Procurement

Renegotiations are a salient element of public procurement

- In *infrastructure construction*, key contract aspects as *price*, *delivery time* and *quality* are often modified ex post:

  - across the globe: from Boston’s *Big Dig* to the Italy’s S-R.C. highway
  - but not only projects, big also countless small contracts:
    - EU Regional Development Found projects:
      - 26% with time delays
      - 21% with cost overruns
    - Italian public works worth >€150.00:
      - 60% has time delays above 20%
      - 14% has cost overruns above 20%
  (Sources: Faber Maunsell/Aecom e Frontier Ec. 2009 and Italy’s AVCP 2000-08)

- Similar for *concessions* (Guasch, Laffont, Straub 2008) and *Public Private Partnerships* (Estache, Saussier 2014)
Why Renegotiations Matter

Renegotiations have impacts at multiple levels:

- For the final users of the infrastructure that are influenced by time delays and quality aspects
- For contracting authorities that are in charge of payments (and ultimately for taxpayers)
- For the firms that might have won the modified contract
- For the overall procurement system as renegotiations can undermine the nature of competitive bidding

But renegotiations are also a “necessary evil” as conditions might change: proceeding as originally planned might be undesirable or, sometimes, impossible
The Legal Approach

Regulate how to respond to different situations in terms of:

- continuing with original contract
- renegotiating some of its conditions
- terminating the contract

For instance, the new EU Procurement Directives identify 5 cases when renegotiation is allowed (Art.72(1) Directive 2014/24/EU):

1. for modifications that had been set out in the contract’s review clauses (meeting certain requirements)
2. for additional works by the original contractor that are necessary, but were not initially included (max 50%)  
3. for unforeseen circumstances (despite diligent behavior) when modifications do not alter contract nature (max 50%) 
4. for changes of operator linked to certain corporate restructuring
5. where the modifications, irrespective of their value, are not substantial and below certain threshold values (10% - 15%)
The Economics Approach

The economic approach is different, but complementary:

- formulates **theoretical models** of firms and CA behavior to design “optimal” systems for continue/renegotiate/terminate choice → mechanism design - contract theory

- **empirically evaluates** these model → reduced-form tests and full blown “structural models” that feed back results to the theory

For instance, this allows assessing potential limits/concerns in the way the new EU Procurement Directives deal with renegotiations:

- Are the cases when renegotiation is allowed adequate?
- Is the quantitative amount of price renegotiation appropriate?
- Why are other (quantitative) margins of renegotiation ignored?
- In practice, how could the system be improved?
At the Roots of Bad Renegotiations

By analyzing some *deep features* of the public procurement problem (asymmetric information; agency; intrinsic uncertainty) the literature points to a few drivers of “bad” renegotiations:

- wrong awarding method for the type of job
- public finance issues: budget cycles, spending cuts and accounting systems
- lack of adequate project design
- lack of adequate administrative coordination
- limits in the legal framework (courts and alternative resolution systems efficiency; public and private monitoring)
Wrong Awarding Method for the Type of Job

Influential theoretical result (Bajari-Tadelis, 2001):

- For contracts involving easily specified jobs: best to write a detailed contract and to auction it off as a fixed price contract through competitive procedures, like first price auctions. In this case, renegotiations should be limited to exceptional circumstances, otherwise risk of perverse effects of competition.

- For contracts involving highly complex jobs: best to leave some margins for ex post adaptations by awarding the contract as a cost-plus contract though more flexible procedures, like negotiations. Renegotiations are a natural part of the procurement process and they should only be regulated to limit abuses (for instance, due to corruption risks).
Empirical Support and Implications

A few empirical studies have confirmed association between awarding procedure and renegotiations amount:

- ex post contract renegotiations (time/price) depend on the choice of the procurement mechanism (Bajari, McMillan, Tadelis, 2009; Lewis, Bajari, 2011 and 2014) and on the level of bid screening undertaken by the buyer (Decarolis, 2014)

- negotiation at the selection stage reduces the likelihood of the contract being renegotiated at a later date (Guasch, Laffont, Straub, 2008) without necessarily increasing prices (Chever, Moore, 2012)

Since (anticipated) ex post renegotiation encourages opportunistic bidding, renegotiations shall be more limited if the awarding stage was a competitive auction.
Limit of the EU Directives

While the new EU Directives expand the scope for “negotiated procedures,” they do not link the possibility/extent of renegotiation to the awarding procedure.

The economics and legal perspectives agree on the usefulness of having enhanced flexibility in the current EU Directives.

But the economics view stresses that a more explicit link should have been established.

Similar arguments hold for other aspects, like the institutional environment: efficiency of courts and dispute resolution systems.
Outline

1. Motivation
2. When to renegotiate
3. Price renegotiations
4. Other margins
5. Conclusions
Price renegotiations are obviously important, even more so in a context of tight budgets like that of many European CA.

The EU Directives give to price renegotiation a special role as they are the only ones for which threshold amounts are set:

- Contracts below EU threshold and with no modification of nature: always allowed up to \(10\%\) of the initial contract value for service and supply contracts and below \(15\%\) of the initial contract value for works contracts.
- For modifications under article 72(1): not higher than \(50\%\) of the value of the original contract or framework agreement. Where several successive modifications are made, that limitation shall apply to the value of each modification.

Are these amounts reasonable? → hard to say.

But open the door for renegotiations up to such amounts...
Price Renegotiation: Threshold Effects

Thresholds tend to matter a lot: due to a variety of reasons (anticipatory effects under pure competition; corruption; transaction costs, etc.)

Example: for the procurement of works, all but 4 Italian regions allow price increases up to 5% under any circumstance

Source: Decarolis, Palumbo 2011
Along with price, several other contractual features matter.

In rough increasing order of measurement difficulty:

1. Time delay
2. Work site safety
3. Quality of the completed work

Some of these features are rather general (price/time changes) other need more contract-specific parameters (safety/quality).
Price and Time Renegotiations are Weakly Correlated: US
Price and Time Renegotiations are Weakly Correlated: Italy
### Safety/Quality: Harder to Measure, but Crucial

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Note: 136 parameters in total. Individual parameter weights range 2 - 10.
Fixing Wasteful Renegotiations: How?

To allow CA to effectively deal with necessary renegotiations, while curbing wasteful ones a procurement system must ensure:

- systematic, reliable measures of contractual performance (price, time, but also quality and safety) (a form of transparency, Saussier-Tirole, 2015)

- ability to make these measure salient for CA and contractors: use of past-performance

- foster competence in CAs: needed to monitor and use performance information

The use of reliable, quantitative performance measure to direct future awarding would also be one (of the few) ways to use technology/big data developments to improve procurement