ESPO FINANCE AND AUDIT SUBCOMMITTEE – 17 NOVEMBER 2014

AGENDA ITEM NO.6

PROCUREMENT AND RISK MANAGEMENT UPDATE

REPORT OF THE DIRECTOR

Purpose of Report

1. The purpose of this report is to act as an update and discussion enabler relating to the risk position within the Procurement activities at ESPO. It reviews the background context; the activity ESPO undertakes, the processes and procedures utilised and highlights areas of ongoing risk and potential future opportunity.

Background

2. The Deloitte's review of 2010/11 established a control mechanism for the legal decisions ESPO makes, ultimately on behalf of its members, relating to the procurement of goods, services and works. The decisions can be subject to the general public procurement framework in the EU stemming from the 1957 Treaty of Rome principles, or specifically under the UK Public Contract Regulations or a matter of contract law.

3. Today ESPO continues to operate a system of panels – both at pre-procurement stage or contract award/variation. The risk approach could be described as having succeeded. Against the backdrop of an ever litigious public procurement environment, fuelled by the macro economics of the last few years and a growing awareness of the legislation, ESPO has not faced formal legal challenge progressing into court action over the last 18 months although the environment remains litigious. See Appendix 1 for recent case law

4. The incoming Assistant Director (AD) Procurement and Compliance, replaced the previous Deputy Director of ESPO as the point of responsibility to chair the panels and advise the Director and its owners with regards to the management of procurement compliance risk. The AD Procurement and Compliance has sought to ensure a healthy balance between compliance and a model of 'good procurement'.

A Broader Risk Agenda

5. In addition to the known legal consequences of not getting public contracting 'right' there is also the imperative to let effective contracts that are fit for purpose but ultimately can seek to drive improved value for money at a time of national austerity, set to continue for the next Parliament.

6. The risk of poor procurement therefore can sensibly be described via a compliance outlook, a good contracting outcomes outlook but also a commercial outlook. ESPO's mandate of being a public owner asset, by the public sector, for the public sector continues. However, the original financial boundaries of a 3.5% return on capital employed have understandably been under scrutiny in recent months.

7. In the scenario of improved financial return there emerges a broader risk agenda which includes the medium term 'funding risk' and also the potential for a changing risk profile.

ESPO's Funding

8. As a summary ESPO current lets circa 200 framework agreements. These are a combination of national, member or individual procurement solutions. They attract typically a 1% retrospective supplier rebate from expenditure through them. ESPO currently receives 43% of its £5m rebate income from just 10 (5%) of its framework solutions. This essentially presents an obvious funding risk from reliability on such a precious few solutions. Likewise, the only other source of funding, day rate consultancy fees produces circa £200k per annum of funding. ESPO is therefore highly dependent from a funding perspective on a relative small number of solutions. See Appendix 2 for full details.

9. The decision on scope of framework solutions also has non-financial considerations. ESPO has a service mandate that stretches beyond the 3.5% return on capital employment investment requirement. As an example ESPO lets a range of procurement contracts that are best served centrally. A recent example is the banking services framework recently let by ESPO following changes in the supplier market. A procurement exercise that required aggregation and time investment to get a solution advantageous to the public sector. The prospect of individual attempts to contract effectively for such services would be both inefficient and highly likely to be ineffective. The actual rebate return from such an investment is low but the service outcome/value is very high.

ESPO's Sales Cycle

10. In addition to the extreme 'Pareto' characteristics of examples income, there is also a noteworthy inherent risk in the type of business and sales cycle. For example to conceive procure and let a new framework may take a year – publishing and uptake to a significant usage level could also be rather protracted. However, by contrast, a decision not to utilise an agreement by customers can be a quick one and this creates a difficult commercial scenario. Each time a major contract is let there is risk at renewal of loses of current custom, at the same time production of replacement solutions is a slow sales process. ESPO therefore needs to be constantly rolling its outlook forward and being prepared to not only retain but have excellent replacement solutions coming through in a timely way if it is to maintain or improve its income from such activities.

The Procurement that Sits behind ESPO's Trading Activity

11. In addition to the letter of compliantly procured and effective framework contracts, ESPO undertakes procurement activity that could be described as 'trading activity.'

12. There are procurement teams that specifically undertake the procurement activity relating to the ability of ESPO to sell goods either via its warehousing operation or indeed via direct delivery. This is some £65m of trade in a year, £40m of which is warehouse throughput; £25m is via direct delivery. There are clearly the same commercial imperatives in this aspect of ESPO's procurement activity. Within ESPO this activity has been characterised as needing to achieve the three C's for procurement. That is it must be customer driven, it must be traded commercially and it must be compliantly procured.

13. In reality these three guiding principles can have a significant tension between them. The AD Procurement and Compliance since joining ESPO in 2013 has flagged as part of a separate report the risks of current procurement practices in this area and this has been the subject of a major risk record (MRR). The commercial and customer aspects have been satisfied but there is long term latent risk in how the products are procured. Examples of such relate to the chronology of contracts to catalogue production, the lack of specification and sampling capability, the need to procure brands for re-sale (which needs to be achieved in a very specific way for public procurement compliance).

14. In addition ESPO has on its P&L some £30m of gas and electricity activity whereby it is providing an end to end procurement and billing service. This activity carries the same potential vulnerability on income as a result of a uncontrollable demand profile i.e. this year as an exceptionally mild winter has pushed down volume and

as a result ESPO income. This covered in more detail later in the report.

A Risk Profile at ESPO

15. ESPO's principle risk management opportunities are as follows:

- The employment and retention/management of procurement professionals
- The use of internal processes and governance – see the Procurement Control Record (PCR) and panels
- The use of a major risk record (MRR) and SMT day to day ownership
- The use of internal audit
- The use of professional indemnity insurance
- Working within the consortium agreement and the tolerances delegated to it as a result.
- Working collaborative on knowledge and activity pan local government (and beyond)

16. Whilst there are a large number of opportunities and tools to support management of risk there is no one formal risk profile. There are iterations of something similar e.g. the MRR escalation based on risk score, the requirement for each procurements risk profile to be scored and approved or referred via the procurement control process and the energy price risk strategy/panel that exist and operate effectively.

Energy Trading

17. Wholesale purchase of energy is undertaken in accordance with a price risk strategy developed in consultation with an approved by customers through a stakeholder Energy Governance Panel. This Panel meets three times a year to review and monitor price risk strategy and actual price performance.

18. Contract terms and conditions limit ESPO's exposure through placing the liability for consumption on the consuming authorities/customers. Customers also carry the price risk on the energy contracted and risk on re-contracting in the event of a supplier's business failure is also carried by customers (ESPO undertakes to carry out any necessary market engagement within existing rebates up to £50k operational cost without further recourse to cost recovery). Generally, ESPO liability limited to the fees recovered from each client.

Delay in Migration of Supply Points to a New Energy Supplier

19. Typically at the time of a change of framework supplier, or when a new customer joins the framework. The principal risk is that if one or more supply points do not transfer to the contracted supplier and

remain with the existing supplier beyond the point at which their contract (and associated prices) expires, the customer will continue to be supplied, but this could be at the suppliers "out-of-contract" tariff rates. These are typically 2-3 times higher than prevailing contract rates. As a rule, however, suppliers do not apply these terms for short term delays due to the additional administrative effort required.

20. Contract terms and conditions put the responsibility and liability for prompt transfer on the new supplier, subject to the provision of timely and accurate supply point data. There is similar provision in the Service Agreements with Customers. In the event the supplier and customer have met their obligations ESPO could be exposed to a claim for meeting any additional costs incurred by a customer, as a result of the act error or omission of ESPO leading to a delay in the transfer of supply points. The process is actively managed by ESPO, with the supplier providing daily reports identifying 'exceptions' during the transfer process – typically in the six weeks leading up to the transfer – to ensure the smooth and timely transfer of all supply points and, in the event of any delays, that these are kept to a minimum so that customers' exposure to "out-of-contract" rates are eliminated or minimised.

<u>Loss of Revenue Due to Customers Not Remaining on Contract on Renewal</u>

21. As the gas and electricity contracts represent a significant proportion of ESPO's rebate income, and all customers on these contracts have the opportunity to make alternative arrangements when contracts are renewed (every three to four years) a major loss of customers on contract renewal could have implications for ESPO's revenue.

22. Individual customers alone do not represent a significant proportion of revenue – a large authority typically equating to between 7-8% of the total, but there could clearly be an impact if a number of such customers chose to remain on the ESPO frameworks at renewal.

23. Customer engagement prior to renewal is key to customer retention and as part of this process, key customers have been identified and have been consulted on the renewal, and dialogue over the renewal is continuing. An assessment based on a RAG principle of the risk of individual customers not renewing is also made, as a result of those discussions, to seek to have an early warning of non-renewal.

24. The timescale for renewal of the gas and electricity contracts is being re-aligned, so that they are renewed 18 months apart, primarily to aid capacity planning. However, this also reduces the risk exposure within a single financial year should a large number of customers not renew.

25. Fee income is collected from suppliers quarterly, so the risk of income being lost due to supplier failure is limited.

Summary

26. The review and management of risk within ESPO remains a significant responsibility of ESPO's SMT working to its owner's delegations and leadership. A background of compliance risk has also developed to include a greater risk awareness relating to our trading activity, achievement of income, our sales cycle and the relationship between risk and return.

27. This paper was aimed at highlighting the activities of ESPO and specifically the procurement staff undertake, the range of day to risks being managed.

28. Members are invited to discuss the risk profile of ESPO, and confirm their comfort in ESPO's management of that risk.

Appendix 1: Recent case law

The 18 procurement-related cases from the UK courts and the European Court of Justice last year are summarised below:

Nordecon AS v Rahandusministeerium (C-561/12) [2013] EUECJ

The European Court was asked whether an authority is free to revise mandatory technical requirements included in its tender documentation as part of the negotiation process in the negotiated procedure, if a non-compliant tender is actually better than the authority's technical requirements would allow.

The Court refused to allow such a negotiation. Where a requirement was mandatory in the tender, it remained mandatory and could not be negotiated away. To do so would undermine the entire nature of a mandatory requirement.

Ministeriet for Forskning, Innovation og Videregaende Uddannelser v Manova A/S (Case C-336/12) [2013] EUECJ

A losing bidder challenged the Danish education ministry for having allowed (at pre-qualification stage) the two winning bidders to submit financial balance sheets after the deadline for submission of applications, and having been alerted to their absence by the ministry. The balance sheets were needed to permit the usual assessment of a potential supplier's financial strength.
The court rejected the bidder's challenge, on the grounds that provided the balance sheets themselves pre-dated the deadline, it was reasonable for the ministry to seek them as part of a post-submission clarification process, when it was normal to correct any obvious errors. The court did however confirm that had the ministry's documentation expressly stated that failure to provide information by the deadline would lead to exclusion, then the ministry could not have requested them, and any bidders concerned would have to be excluded.

Swm Costruzioni 2 SpA, Mannocchi Luigino DI v Provincia di Fermo (Case C-94/12) [2013] EUECJ

This case centres on a conflict between Italian state law, and European law. In European law, an applicant for a tender may cite the resources of third party entities in order to meet qualification criteria, provided that the applicant proves to the contracting authority that it will actually have at its disposal the resources of those entities necessary for the execution of the contract. Italian law limits the number of such third parties to one. The court ruled that European law takes precedence, and applicants may rely on the capacity of as many other parties as appropriate.

Healthcare At Home Ltd v The Common Services Agency [2013] ScotCS CSIH_22

The court rejected a challenge concerning the clarity of the award criteria for a framework agreement. The court said that the criteria were formulated in the ITT in such a way as to allow all reasonably well-informed and normally diligent tenderers

to interpret the criteria in the same way, and in the way intended. The *subjective* views of any particular tenderer do not need to be taken into account by a purchaser when considering a challenge.

Evropaïki Dynamiki – Proigmena Systimata Tilepikoinonion Pliroforikis kai Tilematikis AE v European Commission (Cases T-457/10 and T-474/10) [2013] GC

Evropaïki Dynamiki (European Dynamics, or ED) claimed multiple failings on the part of the Commission in its procurement of information services. These included claims that the Commission should have excluded the winning bidder (whom ED suggested were ineligible because one of its subsidiaries relied on work carried out in a country which was not a signatory to the Agreement on Government Protocol), and that there were errors in the way ED's tender was evaluated. The court rejected all these claims, and dismissed ED actions.

Waste Services Ltd v Northern Ireland Water Ltd & Ors [2013] NIQB 41

This is a Utilities case, so does not *necessarily* apply to local authorities (etc.). The case mainly concerns whether a tender *award* evaluation scheme can involve two stages – e.g. a minimum quality threshold 'hurdle' which a tender must meet in order to qualify to proceed to a second stage of evaluation (which in this case focussed on price). A bidder challenged the purchaser's right to do this, claiming that it blurred the distinction between selection and award criteria. The court however rejected the challenge. This case (along with others) has thrown further light on the *Lianakis* (2008) case, which first established the strict split between selection and award criteria – more recent cases repeatedly imply that it may well be permissible to look at factors normally regarded as selection criteria at award stage, such as experience and resources, provided that the purchaser shows that these are 'properly linked to the subject matter of the contract'.

Montpellier Estates Ltd v Leeds City Council [2013] EWHC 166 (QB)

Leeds City Council conducted a competitive dialogue for the development of a music arena in the city. Montpellier Estates Ltd (MEL) participated, but feared from the start that they were being used by the Council as a 'stalking horse' and could not win, as the Council actually wished to develop its own scheme on its own land. The Council assured them this was not the case, but subsequently terminated the procurement, and duly developed its own scheme. MEL claimed that Leeds had breached the Regulations by prematurely terminating the procurement; and by introducing a public sector comparator secretly and in parallel to the procurement process.

The court rejected MEL's claim, confirming that the Council terminated the procurement at the point it became apparent that it was unlikely to deliver value for money (and in so terminating it the Council avoided imposing on bidders the cost of preparing final tenders). The court also confirmed that the Council had a right to develop its own fall-back solution.

Joined Cases T-339/10 and T-532/10 - Cosepuri Soc. Coop. pA v EFSA, judgment of 29 January 2013

Cosipura is a bus operator in Italy which having failed to win a contract asked to see, amongst other things, the tender submitted by the winning bidder. EFSA declined to disclose this document, which the court agreed they were correct to do, on the grounds that 'a successful tender can fall within the scope of the exception [i.e. the exception to the obligation be transparent in disclosing documentation] relating to the protection of commercial interests and this restriction is integral to the objectives of the EU rules on public procurement, which are based on undistorted competition'.

Case C-115/12 - French Republic v European Commission (26 September 2013)

The case concerned public aid to a company renovating a holiday village in Martinique. The French government had allowed generous tax breaks on the project, which the court said amounted to a public subsidy. When this was added to a separate contribution from the European Regional Development Fund, the project was held to be publicly funded to more than 50% of its cost, and hence should have been subject to the (works) procurement regulations. The French government argued that a tax break was not a public subsidy, but the court did not agree.

European Dynamics Belgium SA and others v European Medicines Agency (Case T-638/11) [2013] GC

The court agreed with the claim of European Dynamics (ED) that the Agency had failed to provide a sufficient statement of reasons as to the grounds for rejecting ED's tender for software applications. The court therefore annulled the Agency's decision not to award to ED.

Covanta Energy Ltd v Merseyside Waste Disposal Authority [2013] EWHC 2964 (TCC)

A competitive dialogue process had already taken six years to conduct when the Authority declared Covanta's bid to be fundamentally unacceptable. Covanta could not use the 2009 remedies (automatic suspension) in challenging the decision – this was not available, as the procurement had begun in 2006, so they instead called for an injunction preventing the Authority awarding a contract.
The court agreed and granted the injunction, on the basis that i) damages (if the contract were awarded and Covanta subsequently won a case) would be almost impossible to assess; ii) given the procurement had already taken so long, the consequence of further delay would be modest; and iii) any sizable damages payment would be a burden on the taxpayer.

Lowry Brothers Ltd and other v Northern Ireland Water Ltd [2013] NIQB 23

The water company (NIW) was facing a challenge to the award of a framework agreement, the grounds for which the court did not consider strong. NIW applied to have an automatic suspension of the award lifted, and the court agreed, stating that even if the case ultimately went against NIW, payment of damages would be an

adequate remedy. (Whilst damages are hard to assess in procurement cases, this does not 'give rise to the proposition that [they] would be inadequate'.)

Nationwide Gritting Services Ltd v The Scottish Ministers [2013] ScotCS CSOH_119

Nationwide Gritting Services (NGS) challenged the Ministers over the non-publication of an OJEU notice for winter road salt supplies; salt was apparently simply being bought from a range of suppliers, without formal tender process on what were claimed to be grounds of extreme urgency. The Ministers rejected NGS's challenge on the grounds that it was launched more than three months after the relevant purchases were made (i.e. it was outside the qualifying period for actions to be brought).

The court however upheld NGS's right to challenge, on the basis that NGS could not have known about the purchases at the time they were made, because no notices of any kind (including a notice of award) were posted. NGS's suspicions that they were missing opportunities to supply were founded on hearsay, market intelligence, and so on. They only knew for certain when they received a confirmatory email reply from the Ministers, and the date of this email was *within* the time limit, so the case was referred for full trial (at a later date).

Corelogic Ltd v Bristol City Council [2013] EWHC 2088 (TCC)

Corelogic challenged the Council's award of a contract, claiming breach of certain obligations under the Regulations concerning provision of feedback, and commenced proceedings within the permitted 30 day time limit. Subsequently Corelogic sought to amend the claim, raising specific objections about the Council's evaluation procedures. The court held that the amendments represented a fresh claim, and it was rejected as ineligible as it was by now outside the time limit. Although Corelogic claimed that the substance of their claim was the same, the court disagreed and even though the amended form apparently presented a far stronger case, the time limit ruling precluded this being considered. The case illustrates to bidders the importance of covering all possible grounds for challenge at the earliest opportunity.

Pearson Driving Assessments Ltd v The Minister for the Cabinet [2013] EWHC 2082 (TCC)

This case concerns the timing of the disclosure of information in a situation where a contract award is suspended as a result of a challenge (in this case by Pearson, an unsuccessful tenderer). The court acknowledged that bidders in such situations are often in a difficult position, but even so did not instruct the contracting authority (the Minister) to disclose documentation ahead of a planned hearing because of the burden this would place on the authority and also because the authority would then not be able to rely on any controversial witness statement evidence in its application. Further document disclosure could be ordered during the hearing itself if this proved necessary.

Roche Diagnostics Ltd v The Mid Yorkshire Hospitals NHS Trust [2013] EWHC 933 (TCC)

Essentially, this case also focusses on the timing of disclosure, but also on *what* documents should be disclosed by a contracting authority to a bidder challenging an award. The Trust had provided some documents to Roche by way of feedback, including spreadsheets created after the award in support of the decision. The court decided that the challenger was in fact entitled to see such documents as were necessary to allow them to take a considered view as to the legality and fairness of an evaluation process. These include instructions issued to evaluators, and contemporaneous records of the evaluation process.

R (All About Rights Law Practice) v The Lord Chancellor [2013] EWHC 3461 (Admin)

In error, in tendering for a contract to provide legal services, R submitted a blank tender form. The tender was rejected on these grounds – an action which R claimed was disproportionate, saying that the matter should have been remedied by post-tender clarification.

The court rejected this claim. Clarification could not deal satisfactorily with a situation where there was effectively no information to clarify. Moreover the tender documentation was clear as to what needed to be submitted and by when, and stated that no amendment would be permitted later. Had the purchaser allowed R to submit a completed tender, then this would have been to the disadvantage of other bidders whose tenders would by then already have been received and opened.

Appendix 2: Income distribution from frameworks

Contract Number	Year 2013	Number	Cum Total	%
272d	506,419	1	506,419	9.3%
653F	349,668	2	856,087	15.8%
860ADD	326,915	3	1,183,003	21.8%
191	295,562	4	1,478,565	27.2%
191 Job 73041	245,694	5	1,724,259	31.7%
79	153,888	6	1,878,147	34.6%
RM1599	136,954	7	2,015,101	37.1%
All Business	118,185	8	2,133,286	39.3%
88	113,690	9	2,246,976	41.4%
191 NNH	109,883	10	2,356,859	43.4%
3A	106,146	11	2,463,006	45.3%
one-off	103,652	12	2,566,657	47.3%
191 NHH Flexi	100,590	13	2,667,247	49.1%
191 NHH	100,193	14	2,767,440	50.9%