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# Policy brief

## Amendments to the contracts: causes and prevention

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## Summary

*Problem statement.* Frequent amendments to the contract create uncertainty in procurement results and become a barrier for the government to perform its functions sufficiently.

*Policy context.* The Law of Ukraine “On public procurement” defines the conditions when a contract may be changed without a new procedure (an amendment to initial contract), but still there are a lot of blind spots and gaps that allow to abuse these opportunities. In Ukraine, amendments to the contract are frequent, and there are doubts about the nature and true legitimacy of decisions to modify the initial contract. So we wanted to discover the reasons for such changes and find solutions to decrease their number.

*Existing solutions.* Mechanisms of avoiding amendments to the contract vary depending on the source of risk that affects the tender and leads to modification.

For market-related risks, various financial instruments (futures, options, swaps), selection of planning horizon (for seasonal global markets) and hard contracting (with proportions according to which the possible risks will be distributed between the contracting authority and the supplier) can be applied.

Hard contracts, precise needs planning (budgeting) and reserves (use of storage) can hedge internal risks of the contracting authority. The supplier can also mitigate his specific risks through hard contracting.

Tender-specific risks should be regulated according to the law (require explanations for “abnormally low prices,” re-evaluate long-term contracts and extend the possibilities to use non-price criteria and different types of contract).

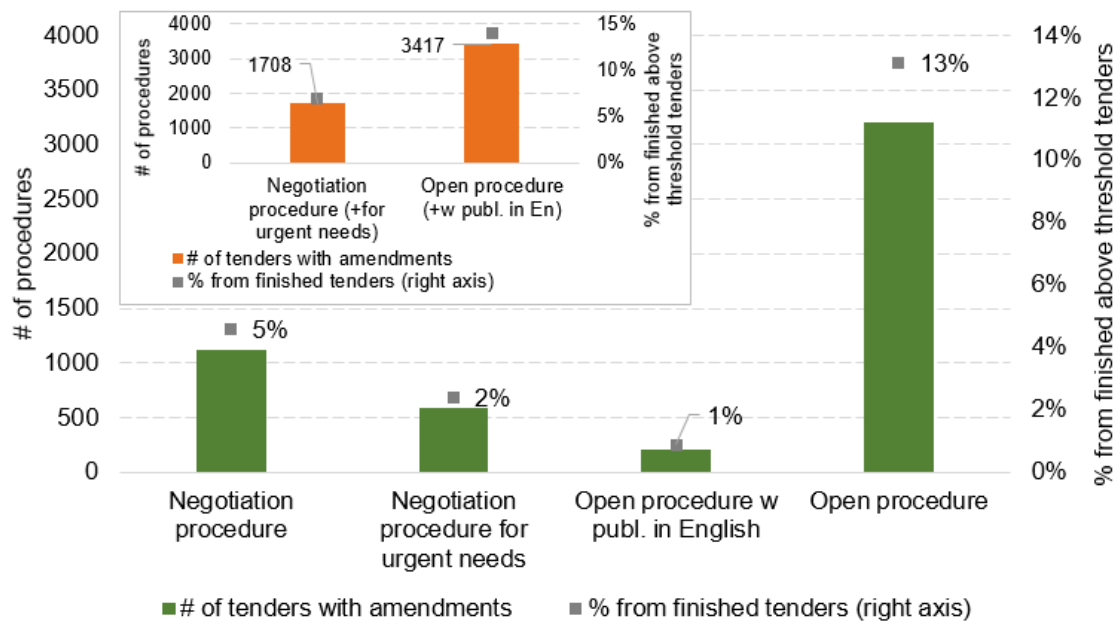
## Introduction/Background

Uncertainty and volatility are substantial elements of Ukrainian economy as a whole. They are a barrier on the way of sustainable development, strengthening of investment attractiveness and innovation growth. Public procurement accounts for a large part of economic performance, so the unpredictability of changes, especially on the stage of contract execution, can have a significant effect on the whole economic environment.

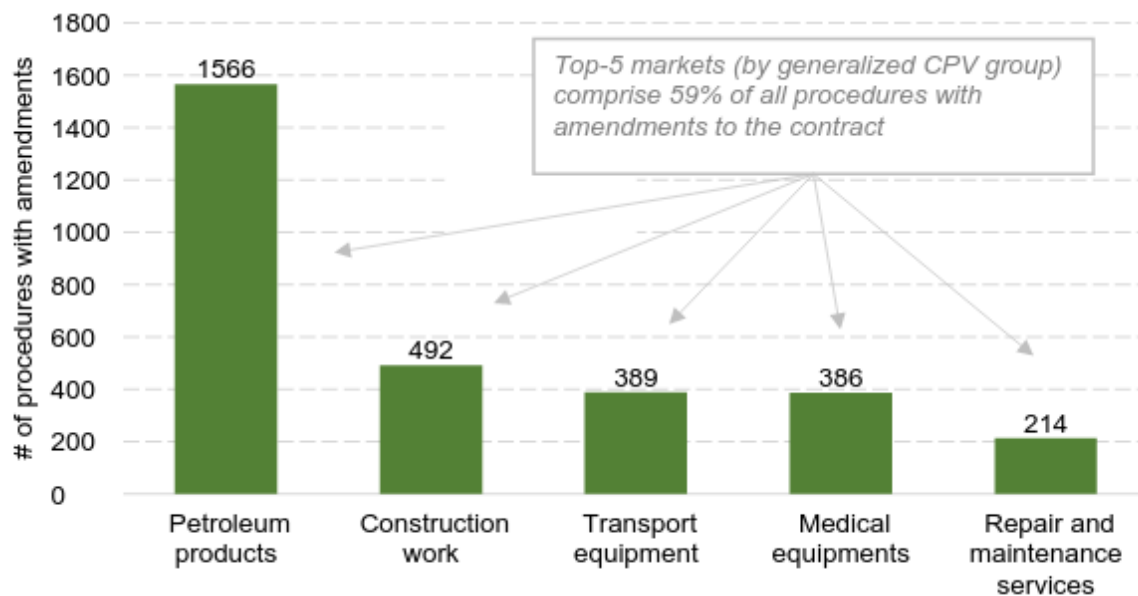
*In Ukraine, amendments to the contract are quite frequent. In addition to the uncertainty of the final costs, it limits the opportunity to satisfy all CA’s needs and deliver public goods/services sufficiently. On the global scale, it can slow down the country’s economic performance (underproduction).*

## Amendments to the contract in Ukraine

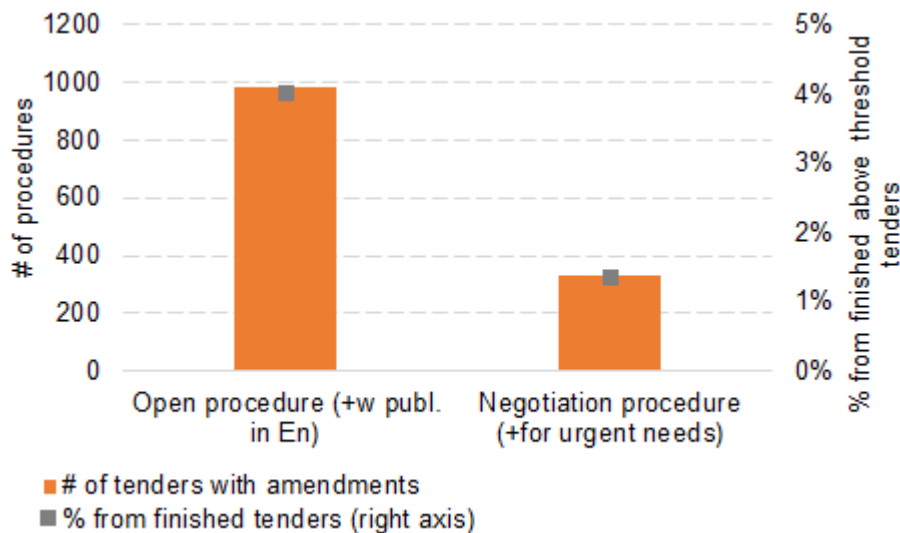
In Ukraine, amendments to the contract happen frequently. Every fifth above-threshold procedure has amendments (among 24,405 above-threshold procedures, there are 5,125 such procedures with amendments to the contract). Changes in contracts are twice as likely to occur in competitive procedures than in negotiative ones (Ch. 1). In terms of market distribution, the market of petroleum products, fuel, electricity and other energy sources tends to have more additional agreements than other markets, and the top 5 markets comprise about 59% of the total number of amendments to the contract (Ch. 2). Change of price is the reason for more than a quarter of amendments to the contract (26% or 1,314 procedures as of the beginning of 2017). Similarly to the general behavior, price changes are more likely to occur in competitive procedures than in negotiation ones – three times more often (Ch. 3).



Ch. 1. Distribution of amendments to the contract by type of procedure



Ch. 2. Distribution of amendments to the contract by market generalized CPV (Common procurement vocabulary – Growth – European Commission, 2017) group



### Ch. 3. Distribution of amendments to the contract due to price changes by type of procedure

#### Reasons for amendments

Any change in factors that affect market participants may be the reason for an amendment to the contract. We should distinguish market-related factors, internal risks of the contracting authority, supplier-specific factors and tender-specific factors.

Market-related factors include changes in raw material prices on the global or domestic market, exchange rate changes, inflation or changes in prices due to increasing demand for goods and services that have to be procured.

The contracting authority can request to modify the contract in case of an emergency or if an additional need arises. It can also signal about problems in planning mechanisms, namely that the contract authority cannot manage its needs properly.

Supplier-specific factors are related to the supplier's capability to fulfill the contract. The capability depends (in addition to market-related factors) on the sustainability of operational and financial activity within the execution period.

And, last but not least, there are tender-related factors where all participants of the procurement process ignore proper verification of the winner's qualification documents, and therefore the winner is not capable of executing the initial contract.

#### Economic rationale

The very foundation of contract law is based upon the assumption of bilateral voluntary exchange. In a market economy, such exchanges involve a process in which the parties bargain voluntarily with a purpose to maximize their economic advantage on terms that are acceptable to the other party (Smith, 1776). The hypothesis is that the initial contract leads to equilibrium and determines "Pareto improvement," in which at least one party is better off and neither party is worse off than would have been the case without the exchange (Farnsworth, 1991).

But there are factors that lead to distortions of the economic equilibrium and Pareto improvement mechanisms, namely the influence of systematic (market) and unsystematic (non-market) risks (Mas-Colell, Whinston, & Green, 1995). Market risk is usually associated with consistent fluctuations seen in the trading price of any particular goods/shares or securities, currency exchange rates or interest rates. Non-market risk occurs because of the unique circumstances of a particular market agent, as opposed to the overall market.

Such risks result in forcing contracting authorities either to change the initial contract (amend the initial contract) or to terminate the initial agreement and conclude a new one. In the first case, we cannot prove the presence of an equilibrium (because CA doesn't have any other choice except to agree to the conditions proposed). Additionally, there is an uncertainty on how the risk will be distributed between the supplier and the contracting authority (probably the whole risk will be placed upon contracting authority, in a situation when the supplier acts as a monopolist). According to the second scenario, a competitive procedure will establish a new equilibrium, but with an additional cost for setting up a new procedure (the cost for transparency). Through competition (bidders are lowering their profit expectations) risk will be distributed between the contracting authority and the supplier, but the proportion of this distribution depends upon the auction results and, in fact, it is also unknown.

Both opportunities (amendments to the contract and a new procedure) lead to uncertain distribution of risks between the contracting authority and the supplier, so there is a probability that increment in the CA's welfare will not be equal to the increment in the supplier's welfare.

### **Approaches to prevent modifications**

In order to overcome the risk distribution uncertainty, several practices may be applied: *hedging via financial instruments* (futures, options, swaps), *hard contracting* (where all the possible market risks and their distribution between the CA and the supplier are written down), and the *selection of planning horizon* (or procure in stock) linked to changes (or seasonality) on the global market.

*Financial instruments* (futures, options, swaps) provide an opportunity (or an obligation) to buy particular goods at a later date at an agreed-upon price and partly eliminate the risk of unexpected price volatility in the future (Graves, & Levine, 2010). But such a tool cannot be fully implemented in Ukraine because of the lack of financial derivatives in use. There is no unified derivative regulation, since the draft of the Law of Ukraine "On regulated markets and derivatives" (Draft of the Law of Ukraine "On regulated markets and derivatives", n.d.) has not been adopted yet, and since, as of now, only specific parts from different regulation documents (such as the Law of Ukraine "On securities and the stock market", the Law of Ukraine "On the depository system of Ukraine", the Law of Ukraine "On the state regulation of securities market in Ukraine") define operations with derivatives. Another aspect is that Ukrainian stock market is weak and dominated by government and corporate bonds; derivatives account for less than 5% in the structure of financial instruments (National Commission on Securities and Stock Market. Annual report, 2015). It should be mentioned that Ukrainians in general are unfamiliar with the terms of the stock market, derivatives and their value for the national economy; the internal level of trust in the system is quite low.

*Hard contracting* allows to set the proportion of risk distribution in case of market changes. It requires continuous market analysis and risk identification by both the contracting authority and the supplier.

In case the global market has seasonal or predictable behavior, the contracting authority can plan and split its purchases and become coherent with fluctuations on the global market. In addition, the CA as well as the supplier can use storage facilities as a within-the-year hedge for seasonal or shorter term price movements (Graves, & Levine, 2010). But Ukrainian legislation prohibits to split the purchase if this need was recognized before, so currently this opportunity is unavailable.

Together with measurements applied by contracting authorities themselves, there are some practices of changes in the procurement process that directly/indirectly affect the frequency of contract modifications:

*Use different types of contracts.* Price criteria as a basic measurement of all Ukrainian procurement procedures is aimed to select most economically efficient price proposal, but in terms of hedging the

risks, it makes contracts inflexible and unadaptable (because of the univocal and discrete price at the date of agreement conclusion); thus, price range or other criteria (e.g. cost) are not provided by the e-system, only through unexpected amendments to the contract. The current system is similar to the system of fixed-price contracts – fixed-price contract (but with opportunity to make changes). International methodology (Types of Procurement Contracts used in Project Management, 2013) suggests two types of contracts: fixed-price and cost-reimbursable contract (when the supplier is reimbursed for the completed work plus a fee representing his profit). Each type (Obj. 1, Obj. 2) has a variety of options to cover price changes depending on the characteristics of a given economic environment.

<b><i>Fixed price contracts</i></b>	<b><i>Fixed-price-with-incentive contract</i></b>	
the price is not subject to adjustment. The buyer and seller agree to performance at the stated price, and the risk of profit and loss passes solely to the supplier.	specifies a target cost and a target profit. When the contractor completes performance, the parties negotiate the final cost, and the final price is established by applying the formula. When the final cost is less than the target cost, application of the formula results in a final profit greater than the target profit; conversely, when final cost is more than target cost, application of the formula results in a final profit less than the target profit, or even a net loss.	
<b><i>Fixed-price-with-economic-price adjustment contract</i></b>	<b><i>Fixed-price-with-price-redetermination contract</i></b>	<b><i>Level-of-effort method of pricing</i></b>
allows pricing to be adjusted upward or downward based on established contingencies such as available business or financial indexes.	used when prices are anticipated to change over time but the extent of those changes cannot be predicted	used in situations when the precise amount of labor or materials is unknown but the parties can agree on a standard level of effort and a given price.

Source: based on Sollish F., Semanik J. *The Procurement and Supply Manager's Desk Reference*

<p><b><i>Cost plus fixed fee</i></b></p> <p>allows the supplier to recover actual costs plus a fee negotiated prior to the contract's inception.</p>	<p><b><i>Cost plus incentive fee</i></b></p> <p>provides an initially negotiated fee with a formula-based adjustment that reflects the relationship of total allowable cost to total target cost.</p>	<p><b><i>Cost plus award fee</i></b></p> <p>provides additional incentive for the supplier to produce excellent results by enabling the buyer to make a financial award in addition to the cost and negotiated fee.</p>
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Source: based on Sollish F., Semanik J. *The Procurement and Supply Manager's Desk Reference*

*Use best practices.* Reform of public procurement is only the first step on the way to comprehensive and sustainable procurement system, and newly introduced law should collect best practices in order to tackle the key problems, i.e. amendments to the contract. Even indirect measurements can be helpful. For example, Polish legislature (ACT of 29 January 2004 PUBLIC PROCUREMENT LAW, 2016) has

adopted several amendments to the law that directly/indirectly affects the frequency of contract modifications:

- a) In order to reduce price dumping (that raises concerns about the economic operator's capability of fulfilling the contract and affects the quality as well as increases the probability of amendment to the contract afterwards), Article 90 of PPL introduced the term "abnormally low price": if the price is 30 or more percent lower than the value of a contract or the arithmetical average of all submitted bids ("abnormally low") the contracting authority must request the bidder to provide additional explanations.
- b) To manage long term contracts (longer than 12 months), the contracting authority is obliged by law to include provisions concerning the basis for making modifications in the contractor's fee in case of changes in VAT rates, the minimum wage, social insurance or health insurance coverage or rates (Art. 142(5))
- c) To avoid overestimated costs and ensure the proper quality of procured goods, Polish legislation limits the use of the price criterion: Art. 91(2a) provides that the price may be used as the sole criterion only in situations where the subject matter of the contract is widely available and has established quality standards.

Graves and Levine (Graves, & Levine, 2010) suggest diversifying hedging methods by splitting a single procurement into several contracts with different hedging approaches (make storages, use financial instruments and buy at spot prices). But currently the "portfolio theory" is not applicable in Ukraine, as Ukrainian legislation prohibits to split the purchase if this need was recognized on the planning stage.

## **Recommendations**

- Develop and promote the usage of financial instruments to avoid market-related risks.
- Explain the importance of precise contracts with proper risk assessment for hedging from market-related risk and eliminating non-market risk.
- Develop legislation to ensure price dumping, set different evaluation rules for contracts with different duration, promote and make possible the use of different types of contract, extend the opportunities for non-price criteria application to get rid of tender-specific risks.
- Promote adaptive budgeting and motivate the CA (contracting authority) to procure in stock (make reserves) in case of internal risks.

## **Annex A. Legislation**

European public procurement practice was partly adopted under the Law of Ukraine “On public procurement,” so regulations on amendments to the contract in both the EU and Ukraine are similar; however, in Ukraine, there is an emphasis on the regulation of price changes due to economic circumstances.

In Europe, the legal background of contract modifications during their term is represented by the Directive 2014/24/EU (DIRECTIVE 2014/24/EU, n.d.) of the European Parliament and the Council. Article 72 of the Directive determined five cases of modifications when contracts may be modified without a new procurement procedure: (a) modifications have been provided for in the initial procurement documents in clear and unequivocal review clauses; (b) for additional works, services or supplies by the original contractor that have become necessary and were not included in the initial procurement where a change of contractor cannot be modified because of reasons clearly defined in the Directive; (c) where the need for modification has been brought about by circumstances which a diligent contracting entity could not foresee provided that the modification does not alter the overall nature of the contract and does not result in a price increase in excess of 50% compared to the initial value of the contract; (d) where a new contractor replaces the one to which the contracting entity had initially awarded the contract; (e) where the modifications are not material.

Article 36 of the Law of Ukraine “On public procurement” (Law of Ukraine “On public procurement”, n.d.) defines the following cases when the contract amendment can be carried out: (a) the amount (quantity) of procurement has been reduced; (b) the price for a unit changed by a maximum of 10 per cent in case of price fluctuations in the market, if such an adjustment does not increase the amount specified in the contract; (c) the improvement of the quality of the item procured, if such an improvement will not result in any increase in the amount specified in the contract; (d) the duration of the contract was prolonged, in cases when there are documented objective circumstances that caused such prolongation; (e) a lower price was agreed upon (for the same quantity and quality of goods, works and services); (f) the price was changed due to the changes of tax rates, in proportion to such changes; (g) the consumer price index established by state statistics bodies under the law have changed, or in the case of changes in foreign currency exchange rates or Platts quotes; (h) the terms and conditions changed in relation to the application of provisions of Paragraph 5 of the Article 36.



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