



Briefing 10/23 May 2010

# Cover pricing in the Construction Sector – Current Position and Implications

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To: All housing email contacts

## **Key issues**

The OFT has found that bid rigging in the form of cover pricing is endemic in the construction sector

The full decision shows that the OFT have only been able to send a warning shot by reaching findings on a limited number of cases due to resource constraints

25 Appeals have been filed but largely relating to the level of fine

Issues of financial loss are complex to prove but should be reviewed

Public sector projects are particularly affected

Tender processes will need to be significantly reviewed to ensure best value is achieved

## **1. Introduction**

The OFT Decision issued on the 21<sup>st</sup> of September 2009 raises significant issues for construction tendering, both in terms of past and future projects. Total fines of £129.5 million were imposed on 103 construction firms in England for collusion with competitors on building contract tenders. The findings relate to 199 separate sites and 86 of the relevant companies benefited from a penalty reduction under the leniency programme by admitting infringement and giving evidence to assist the OFT in its investigation.

## **2. What is cover pricing?**

The majority of the infringements established by the OFT were in the form of cover pricing. This is where one or more bidders in the tender process agree in advance for a

competitor or competitors to submit an artificially high price for the works. These “cover bids” are priced with no intention of winning the contract. They are however submitted as if they were genuine bids so giving a misleading impression to the client as to the extent of competition. The OFT identified 11 tenders in which there was no genuine competition at all as all the bidders colluded. In 6 instances the OFT found evidence of payments being made between competitors in connection with cover pricing.

### **3. The tip of the iceberg**

The OFT has confirmed that its investigation revealed that cover pricing and bid rigging is endemic in the construction industry. It uncovered specific evidence of this practice in over 4000 tenders, estimated to be worth around £3bn, involving over a 1000 companies and concludes that beyond this many other companies will also have been engaged in these practices. On the OFT’s findings the total construction cost of all projects affected across the country in the period under investigation (March 2000 to June 2006) is very difficult to assess but would be a huge sum.

A very notable feature of the findings however is that very few of the infringements included in the Decision itself concern large projects by construction standards. The largest was worth £8.5m, only 5 exceed £5m and only 23 exceed £2m. This leaves the prospect that many much larger projects may have been affected, particularly for example in London which hardly features.

As the investigation developed the OFT largely followed the connections presented by the most readily available evidence. This accounts for the geographical concentration of infringements in the East Midlands and the neighbouring areas of Yorkshire and Humberside. The OFT were however satisfied that a concentrated investigation in any other geographical areas would have produced similar results. Equally the OFT concluded that cover pricing is prevalent in all corners of the construction industry from the smallest players to some of the largest and best known names in the sector.

### **4. Public sector impact**

Although private companies were also affected, the greatest impact of cover pricing appears to have been in relation to public sector projects. The appendices to the Decision identify the site but not the client. However a rough review of the 199 infringements found, suggests that in around 75% of cases the relevant construction works were carried out for public sector organisations, housing associations, charities or educational establishments or in relation to local amenities. Even if this picture is not fully replicated across all relevant projects over the period under investigation, it is apparent that the public sector has been particularly affected.

### **5. OFT approach and its implications**

Following the release of the OFT’s full Decision, running to more than 2000 pages, in December 2009, the extent to which the scope of the investigation and findings were cut back for resource reasons becomes apparent.

It is important to understand the methodology adopted by the OFT in order to appreciate the significance of the Decision in proper context. The bid rigging investigation was initiated by contact from the Internal Audit Manager from a Hospital NHS Trust in Nottingham on 1 April 2004. This led to so called dawn raids on construction companies, the gathering of evidence and further inspections. At various stages of the 5 year investigation, companies applied for leniency – by admitting allegations and informing the OFT about new instances of bid-rigging. As a result the investigation snowballed.

By the beginning of 2007 the OFT had obtained evidence of bid rigging activities in relation to many thousands of tenders throughout England. It needed to focus its resources to produce an outcome that would make best use of limited resource, concentrate on repeat offenders and provide the most effective deterrent to all companies in the shortest time possible. It therefore made a selection of tenders for further investigation at the same time as closing the door to further leniency applications. Fast track offers of a 25% reduction of any financial penalty imposed were made to 85 companies that had not already applied for leniency and for which there was evidence suggesting involvement in a minimum of 5 and maximum of 20 tenders. Of these companies, 45 then responded by admitting engaging in bid rigging activities in connection with some or all of the suspected tenders.

Further steps were then taken to consolidate the investigation. In relation to those parties that did not apply for leniency only a maximum of 3 infringements were pursued by the OFT in the regulatory proceedings. In the Decision itself the OFT included a maximum of 3 infringements per non leniency party. Although leniency applicants were in many cases found to have been involved in more than 3 infringements, financial penalties were imposed in relation to a maximum of 3 infringements only.

The approach the OFT necessarily adopted emphasises the vast scale of the problem. The Decision only covers a small sample. Where infringements are listed in the Decision, in many cases only some of the parties that submitted tenders are found to have been involved in cover pricing. This in itself however may partly be explained by the methodology adopted and limitations of regulatory resource.

## **6. Regulatory appeals**

Of the 103 construction firms named in the decision, 25 have filed appeals with the Competition Appeal Tribunal and one other was barred from filing late. Of the 25 appeals, 19 are solely contesting the level of the fine, and are not made on the basis there was no involvement in any cover pricing activity. Of the 6 appeals that go further, 3 claim either that a subsidiary was not acting as an agent of its parent company or that there is insufficient evidence for one (but not all) of the infringements found.

Of the remaining 3 appeals, 2 claim that the evidence was not to the 'requisite standard of proof', or that there was 'insufficient evidence'. Only one construction firm expressly denies that it was a party to any infringement. Many of the appeal submissions in relation to fines refer to the methodology adopted by the OFT and seek to challenge the fairness of the process given its selectivity.

The case management conferences for each appeal will be heard at the end of June and in the first half of July 2010. We are unlikely to see the judgments reported much before the end of the year. At that stage, some of the parties may seek permission to appeal to the Court of Appeal although such appeals are limited to points of law.

## **7. Construction industry explanation**

Evidence from construction companies confirmed that cover pricing has been a long established practice and is even referred to in some construction text books. The almost universal explanation for the practice from within the industry describes it as a means for a company to remain on a tender list, without having to commit the resources and expense of calculating a genuine bid where it did not want the job. The OFT accepted that construction companies perceived there to be a risk in simply refusing to tender, but noted that it was given few examples of companies actually being removed from tender lists as a result of tender requests being turned down.

From a regulatory standpoint the OFT emphasises that cover pricing is illegal and even alleged ignorance of illegality is at least negligent. It also points out that at the very least participants in cover pricing must recognise that they are undermining a process which is intended to be competitive so misleading the client. The appeal to the Competition Appeals Tribunal in Apex Asphalt –v- OFT resulted in a finding in 2005 to that effect in the context of bid rigging in the roofing sector and concluded that cover pricing was a competition infringement. The argument run by Apex in that case that its aim was to preserve its position on tender lists was unsuccessful. It is also worth noting that in many cases tender documents will have included a provision requiring tenderers not to collude.

In a 2006 survey carried out by the Chartered Institute of Building of 1404 respondents within the construction sector, 5% thought cover pricing was not at all corrupt, 32% that it was not very corrupt, 45% that it was moderately corrupt and 18% that it was very corrupt. This compares with percentages of 4%, 18%, 21% and 57% respectively in the same survey for each of the same categories but in relation to bribery to obtain a contract.

## **8. Have financial losses been incurred?**

The extent to which cover pricing results in an actual financial loss is not clear cut and will critically depend on the facts of each tender.

It is not the case, as has been suggested, that the OFT have found there to be no financial loss. The OFT has simply not undertaken this analysis and has made no findings in this respect for two reasons. Firstly, it does not need to in order to establish a regulatory infringement resulting in fines and provide the deterrent it aims to achieve for the future. The legal definitions surrounding Chapter 1 infringements necessitate that a practice need only have the object *or* the effect of restricting competition to be caught by the prohibition. This means that cover pricing is considered to be an *a priori* infringement irrespective of whether prices actually change. Secondly, the evidential requirements on the OFT to prove an effect would have been far more onerous, and opened many more avenues of appeal. This has effectively been left to the parties affected to review and if appropriate to pursue for themselves.

If, as the construction companies are in many cases suggesting, a winning bid is calculated fairly, and in addition to 'supporting' bids there are other genuine bids, then the contracting party is still likely to lose out as a passive effect of being deprived of genuine competition. The general result of cover pricing will be a reduction of competition leading to increased prices. The fact that the client is not told of the collusion means that there is no opportunity to include another tenderer.

In addition, there are a range of possible outcomes in relation to specific tenders that may result in financial loss. Knowing that fewer parties were bidding may encourage the submitter of a genuine bid to increase its figure accordingly. For the cases where cover prices were given to multiple competitors, the temptation to raise a bid would logically be higher.

The OFT noted that in the vast majority of cases the actual arrangement of the cover price was carried out by telephone. It is therefore difficult evidentially to establish whether it was instigated by the winning bidder or, as construction companies have maintained, that the request to take a cover price invariably came from the company that had decided it did not wish to win the job.

In some cases the OFT found that all the companies tendering colluded and in a small minority that there were "compensation" payments made. Cases of this nature should be reviewed carefully. There are also, for example, sites where only some of the tenderers were found to be involved in cover pricing but all of the other tenderers, for whom no such finding was made in relation to that site, were found to have been involved in cover pricing on other sites. In view of the selective nature of the OFT investigation it cannot be assumed that all stones have been turned even in relation to the sites which are included in the Decision.

The task of identifying loss in cases not included in the Decision will be more difficult as evidence of cover pricing will first need to be established. Given the endemic nature of the practice, the likelihood that parties found to have infringed in some cases will have infringed in others, and the OFT's indication that a great number of other companies will also have been involved, it may however be prudent to conduct a review of those tenders over the relevant period which have involved larger scale expenditure and/or where there are any clear indications that cover pricing may have taken place.

One obvious step that could be taken is to review the professional advice originally received prior to putting the job out to tender. This will generally have included a scope of the works required and a budget estimate. There can be many reasons why that estimate may be inaccurate but if it is substantially less than the lowest bid received that could indicate a cause for concern and further investigation. Where cover pricing can be shown to have occurred the difference between that estimate and the price paid could also provide a starting point for the amount which could be claimed.

In practice the complexities of proving loss are such that few cases are anticipated. This does not however mean that given the right evidence a recovery could not be achieved.

## **9. Right to claim**

If cover pricing resulting in financial loss can be shown to have occurred on the balance of probabilities, it is now well established that a claim for compensation can be made. If there is an existing regulatory finding of infringement then it is possible to apply to the Competition Appeal Tribunal. Otherwise it is still possible to bring a claim in the High Court but this there is then the additional hurdle of proving the infringement as well as the resulting loss.

## **10. Level of fines**

The fines levied by the OFT in its Decision are low in comparison to the maximum limits available. Furthermore the Government has indicated that findings of infringement should not cause the relevant companies to be removed from tender lists. This is largely a pragmatic recognition of the prevalence of the practice as well as of the current economic climate. In future it can however be expected that offenders will be dealt with much more rigorously.

## **11. Comments on impact in relation to the public sector**

There is little doubt that tendering practices and procedures will need to tighten significantly in the light of the OFT's findings. The endemic and deep rooted nature of cover pricing means that a profound cultural change will be needed to eliminate it from the construction sector and ensure that best value is achieved.

Decisions about which contractors councils should use are for councils alone and although the OFT have stated that contractors should not necessarily be dropped from tender lists purely on the basis of being investigated, councils will want to take this into consideration when identifying who they work with in future.

OFT findings highlight that cover pricing is endemic in the construction industry across large and small companies, a fact admitted by many of those interviewed as part of the investigation. As such changes to the culture within the industry will take a long time.

APSE has previously made a series of recommendations as follows:-

- the OFT to investigate a number of tenders/contracts each year as part of a programme of checks to ensure companies do their best to stick to the law
- all companies submitting tenders to public sector clients to sign an agreement stating they have not been investigated by the OFT as part of this or any other investigation or stating the extent to which they were investigated. This will ensure those responsible for spending public funds do so from an informed standpoint
- any company named in the report to make a public statement declaring the actions they are taking to tackle the points made in the OFT report
- industry bodies to work with the OFT and public clients to establish procedures to bring inappropriate practices into the public domain

Future reductions in budgets will inevitably put more pressure on councils to identify savings and best use of resources and they must ensure they are not victims of illegal

activities in this or any other sphere. They will be expected to ensure their skills and knowledge of procurement issues are appropriate and that they have adequate procedures in place to avoid getting into a position which cannot be justified as best value.

**Previous relevant briefings by APSE**

09/35 'Confessing to cartels in Scotland'

08/23 'OFT publish statement of objections detailing alleged collusion by construction companies'

07/47 'Making competition work for you – a guide for public sector procurers of construction'

07/42 'Firms identified in OFT investigation'

07/22 'OFT details investigations into construction cartel'

06-41 'OFT report on waste competition'

06-18 'OFT cartel busters unit investigation into Mowlem'

03/59 'Action against cartels (prepared by Eversheds)

Two OFT press releases also provide information on the investigation – 'OFT closes door on cartel leniency in construction bid rigging cases in England' (50/07) and 'OFT makes 'fast track' offer in biggest ever UK cartel investigation' (49/07).

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