



**RISKS ATTRIBUTED TO SUBCONTRACTING IN
PUBLIC PROCUREMENT SYSTEM**

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The report was prepared with the financial support of
the Norwegian Ministry of Foreign Affairs



Norwegian Ministry
of Foreign Affairs

I. EXECUTIVE SUMMARY

Substantial reforms in Georgia's public procurement system started in 2010 and this process is still going on. During this period, Georgia has had a big progress, especially, in terms of digitalization of procurement system and increasing transparency. Nevertheless, some significant challenges, also described in the latest research¹ of Transparency International Georgia, still remain.

One of the challenges is related to a lack of transparency in subcontracting. Subcontracting of certain services in public procurement is a common practice in many countries. It enhances capacity and competitiveness of relatively small companies by promoting cooperation. However, subcontracting has led to such problems and risks in Georgia's public procurement as: a lack of transparency in full procurement cycle and difficulties in detecting potential corruption deals. These problems in certain cases had a negative impact on a quality of provided goods and/or services.

II. INTRODUCTION

In 2012-2017 Georgia has significantly reformed its public procurement system that has attracted a big public interest in and outside the country. Creation of electronic portal, increased transparency and reduction of corruption risks have been especially appraised.

Despite many positive features of existing procurement system, it still requires further improvement. One of the main challenges is related to transparency and legislative framework of subcontracting. Use of subcontractors often diminishes such positive sides of public procurement as transparency, low corruption risks and efficiency.

The companies awarded with public procurement contracts often fulfill their contract obligations through subcontracting. If a company that wins a tender or gets a simplified procurement contract does not have enough capacity to fulfill its obligations, it signs subcontracts with other companies (subcontractors) that partially or fully accomplish the assigned tasks. However, only primary contractor company is fully responsible for completion of contract obligations, subcontracts do not have any kind of liabilities towards public procurer institutions.

Georgian legislation allows companies to participate in public procurement jointly with other companies. However, specific legislative norms that regulate this kind of cooperation more thoroughly do not exist.

This policy document describes problematic features and specific cases of subcontracting in Georgia's public procurement. In addition, it provides concrete recommendations for improving subcontracting practices focusing on commitments taken by Georgia within the framework of EU-Georgia Association Agreement. The presented recommendations, if taken into consideration, can increase trust and competitiveness of companies participating in public procurement, reduce corruption risks and have positive impact on a quality of provided goods and services.

¹ *How the State Spends Our Money*, Transparency International Georgia, 2017
<http://www.transparency.ge/en/post/how-state-spends-our-money>

III. PROS AND CONS OF SUBCONTRACTING

Subcontracting allows small and medium companies to participate in public procurement process. Since the state is one of the largest and stable procurer, getting public procurement contracts can be crucial for many companies. Subcontracting means that at least two companies unite their resources. This can increase their size, income, experience and capacity.² Moreover, administrative burden of participating in public procurement mainly lays on primary contractor company not on subcontractors.

Georgian public procurement legislation does not regulate the issue of subcontracting. Only general civil legislation applies to the relations between primary contractors and subcontractors. During the tender procedures and implementation of contractual liabilities a supplier does not have any obligation to notify relevant procurer about subcontractors, unless, procurer in tender requirements specifically writes it. Therefore, restricting and regulating subcontracting practice is solely up to procurer institution and it is not mandatory. Certain procurers have some experience in regulating subcontracting rules in tender documentations. For instance:

1. Documentation of a tender announced by the Georgian Oil and Gas Company (GOGC) on rehabilitation of Gori-Kareli 20 km long part of East-West Natural Gas Pipeline (Phase IV) says:

“The contractor does not have a right to sign subcontracts for conducting partial or full work required by the contract without written consent of GOGC. Such consent will not abolish any kind of contractual liabilities taken by the primary contractor and it is still solely responsible for any actions and lapses made by subcontractors and their personnel”

2. Georgian Melioration LLC, internal renovation works of Mtskheta service center.³ The tender documentation says:

“The supplier is allowed to sign subcontracts only with the consent of the procurer. In order to get such a consent the supplier should provide names of subcontract(s) containing the information on works that should be done. The share of subcontract(s) should not exceed 40% of total contract costs. The procurer has a right to refuse subcontracting.”

If a procurer right from the beginning does not set certain rules for subcontracting, it can create several risks:

1. Lack of transparency and public access to the information. It would be impossible to define which company fulfilled the contractual obligations and was paid taxpayers money. Such an ambiguity increases corruption risks because subcontractors could be closely affiliated (former business partners, friends or relatives) with the government or they could be donors of the ruling party. Moreover, lack of transparency can be misused by signing subcontracts with the companies that have a bad reputation.
2. Subcontracts could be signed with companies that does not satisfy the requirements set by the procurer. It can cause serious risks in terms of low quality of provided goods and services and delays.
3. Some companies could agree in advance and avoid competition with one another. When one of them gets a contract, it can share some part of works with other company. In this case, goods or services bought by the procurer will be more expensive compared with the price achieved through competitive process.

² Subcontracting in Government Marketplaces, Kathy C. Potter and Sharon A. Roach, Benton Potter & Murdock, P.C

³ <https://tenders.procurement.gov.ge/public/library/files.php?mode=app&file=1354684&code=1442339210>

4. The work experience of subcontractor can be unfairly attributed to the primary contractor that will allow this company to win more tenders in future at the expense of subcontractors. Such company only formally will meet the tender requirements.

IV. PROBLEMATIC CASES

Since the information on subcontractors is not transparent, it makes more difficult to detect such cases when failure or deficiencies in implementing contractual obligations was caused by subcontracting. We discuss couple of problematic cases taken from the State Audit Reports, our and other organizations research documents.

1. RENOVATION OF METRO STATION AKHMETELI - COMPETITOR AS A SUBCONTRACTOR

On January 30, 2018 in Tbilisi, the ceiling of Metro Station Varketili fell down and injured 14 persons. Kvarelremsheni LLC did the renovation works of the metro station in 2017. When studying this case the Institute for Development of Freedom of Information (IDFI) found an interesting fact that was related with subcontracting.⁴

In addition to Metro Station Varketili, Kvarelremsheni LLC won a tender on renovation of another Metro Station – Akhmeteli. This tender was announce one week prior to the tender of Varketili Metro Station. In this tender Kvarelremsheni has one competitor – Damba LLC. Kvarelremsheni's bid was GEL 447 728 and Damba's - GEL 523 215. These bids have not changed during the tender; therefore, Kvarelremsheni won the contract. However, tender commission found certain lapses in Kvarelremsheni's documentation which have been addressed by the company, but the tender commission found more deficiencies that were absent in the documentation submitted earlier. Since the legislation does not allow correcting mistakes twice, Kvarelremsheni was disqualified. As a result, Damba won the contract with GEL 523 215 bid.

On December 12, 2016, Damba signed a contract with the procurer - Tbilisi Transportation Company - and at same day Damba subcontracted Kvarelremsheni for renovation works of Metro Station Akhmeteli. According to this subcontract, Kvarelremsheni would get GEL 491 822 that is more than this company's initial bid before it was disqualified.

IDFI argues that this case can be considered as an example of bid rigging in public procurement defined by the OECD, when a competitor deliberately presents a deficient offer that will be inevitably denied by the procurer. Ultimately, the sides of such deal split contract money with one another.

2. THE CASE OF ISANI DISTRICT GOVERNMENT – CONTRACTOR RELYING ON SUBCONTRACTING

On August 6, 2015, the Isani District Government signed a simplified procurement contract with GBC Group LLC for conducting renovation and construction works. With the consent of Tbilisi City Council, unforeseeable circumstances were named as an official reason for using simplified procurement procedure instead of tender. At the time of contract signing, GBC Group did not have any experience in public procurement. Renovation and construction works should have been finished by December 20, 2015.

⁴ Alleged illegal deal in the tender of Metro Station Akhmeteli, IDFI, 2018 https://idfi.ge/ge/possible_deal_in_terms_of_metro_akhmeteli

Due to delays in getting expertize results and dislocating population, the company could not start preparatory works on time. In the meantime, the conditions of a building that should have been renovated worsened and there was a serious risk of its demolition. As a result, the subcontractors refused to do their work and the contract failed.⁵

Due to a lack of transparency in subcontracting, it is difficult to assess what role the subcontractors played in work delays. Moreover, we do not know how much time GBC Group has spent in searching and signing subcontractors. However, according to the official documentation, the subcontractors refused to fulfill their contractual obligations.

This case shows that inexperienced company took contractual liabilities solely relying on the experience of subcontractors that ultimately led to a failure.

3. THE CASE OF GEORGIAN RAILWAYS, JSC – WORK EXPERIENCE AT THE EXPENSE OF SUBCONTRACTORS

According to the audit report of the State Audit Office⁶, Georgian Railways, JSC, usually required work experience of a primary contractor or subcontractors. In some cases, the tender winners and participants presented only the work experience of subcontractors. As a result, the primary contractors accumulated work experience in construction at the expense of subcontractors, but they may not conduct construction works by themselves in future when they will easily meet the tender requirements in terms of work experience.

The table below shows the cases when the contracts have been won solely at the expense of subcontractors' experience.

SPAN	Work to be conducted	Contractor	Subcontractor	Contract value (USD)
SPA140030296	Construction work	Elita Burji LLC	Khidmsheni JSC	1 496 961.00
SPA150016387	Construction work	Elita Burji LLC	Khidmsheni JSC	1 223 681.00
SPA150000671	Construction work	Elita Burji LLC	Khidmsheni JSC	327 347.00
SPA150000673	Construction work	Sakharia LLC	Khidmsheni JSC	211 606.00

⁵ Procurements Conducted in the Tbilisi City Hall System in 2014-2017, Transparency International Georgia, 2017 <https://goo.gl/qVCW64>

⁶ Georgian Railways, JSC, Compatibility Audit Report /36, State Audit Office, 2017 <https://www.sao.ge/files/auditi/auditis-angarishebi/2017/rkinigza.pdf>

4. THE CASE OF SAMTREDIA MUNICIPALITY – A LACK OF TRANSPARENCY IN SUBCONTRACTING

According to the report⁷ of the State Audit Office, in 2012 the Municipality signed a contract with DAGI+ LLC, in order to renovate four streets of Samtredia. The contract value was GEL 749 300. The supplier was not allowed to use subcontractors. Nevertheless, DAGI+ subcontracted Latex LLC that conducted the work valued GEL 412 300. What is even more interesting, according to the presented documents, DAGI+, apparently, started renovation works couple of days prior to the signing contract with the Municipality.

The similar case was observed in 2013 when Latex, without the consent of the Municipality, subcontracted DAGI LLC that conducted renovation works valued GEL 889 700 while the total value of contract was GEL 2 635 000.

A number of such cases can be significantly reduced if public procurement legislation sets higher information transparency standards for subcontracting. Proper regulations will simplify monitoring and detection of such problems that, in turn, can decrease corruption risks in public procurement.

V. THE EU DIRECTIVE

In the process of association with the European Union (EU), Georgia committed to harmonize its public procurement legislation with the relevant EU directives.⁸ This process should be fully accomplished by 2022 and is divided into 4 phases. The first three-year long phase finished in 2017 that envisaged harmonization of primary institutional and regulatory base with the directives of the EU.

The second phase will be accomplished in 2019 and among others, it also includes the issue of subcontracting. More specifically, certain subcontracting rules should be introduced that will allow procurers to have more power in this regard. Some subcontracting rules as direct payment possibilities given in the directive are not mandatory.

The EU Directive 2014/24/EU⁹ regulates public procurement issues. The article 71 of this directive calls on EU member states to ensure transparency in entire chain of subcontracting. It allows procurers to be informed which company conducts works on the ground. The primary contractor should be obliged to inform procurers on subcontractors and their sustainability. If subcontractor is incapable to fulfill its contractual obligations, the primary contractor should have a possibility to replace it. In addition, Georgia will have a freedom to introduce regulations that are more comprehensive in this regard.

Procurers should have a right to require full information on potential subcontractors, including planned volume of their work, from procurement participants. Procurers should also have a right to require all information on any changes in subcontracting.

⁷ Compatibility Audit Report on Samtredia Municipality Financial Activities State Audit Office, 2014
<https://sao.ge/files/auditi/auditis-angarishebi/2014/adg-samtredia-shesabamisoba.pdf>

⁸ The Government Decree #536, March 31m 2016
<https://goo.gl/5rvfHx>

⁹ DIRECTIVE 2014/24/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL, 26 February 2014

VI. CONCLUSION

Despite the Georgian public procurement system meets high transparency standards, subcontracting remains an exception. The information on subcontracting is almost absent. Due to a lack of information, it is hard to have a full picture on problematic issues existing in subcontracting practices. It is also hard to detect the conflict of interest and political corruption cases.

In fact, subcontracting remains a hidden side of public procurement process, which should be focused on avoiding malpractices in this regard. The EU directive, which is mandatory for Georgia, obliges it to make subcontracting information more transparent and accessible.

OECD reports¹⁰ show that subcontractors can be used for getting an unfair advantage over other competitors when primary contractor and subcontractors make an illegal deal.

VII. RECOMMENDATIONS

- 1.** Although the EU requires from Georgia to introduce certain rules for subcontractors by the end of 2019, our country should fulfill this obligation as soon as possible since it causes many problems. Regulating subcontracting can further increase transparency, effectiveness and trust in public procurement system;
- 2.** It should be mandatory to publish full information on subcontractors on electronic procurement platform. At least the names of subcontractors, the content and value of contract should be publicly available. This information should be provided in machine readable format in a specific section designed for subcontracting;
- 3.** In the meantime, the procurers should regulate the issue of subcontracting by elaborating proper procurement procedures (For instance, eligibility requirements not only for primary contractors, but also for subcontractors, ceilings for the use of subcontractor work, etc.);
- 4.** If a primary contractor fulfills its contractual obligations mostly through subcontracting such work should not be counted as work experience.

¹⁰ <https://www.oecd.org/competition/cartels/42851044.pdf> <http://www.oecd.org/gov/ethics/48994520.pdf>