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COLLUSION AND CORRUPTION IN PUBLIC PROCUREMENT

Contribution from Mexico

-- Session V --

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COLLUSION AND CORRUPTION IN PUBLIC PROCUREMENT

-- Mexico --

1. This note summarises Mexico's experience in public procurement contracts from a competition policy prospective. Section 1 describes the relevance of public procurement in Mexico, while section 2 outlines the corresponding regulatory framework. Section 3 identifies competition and corruption concerns associated with this regulation. Section 4 summarises some bid rigging cases and their potential relationship with public procurement regulation and corruption. Finally, section 5 presents some concluding remarks.

1. Relevance of public procurement¹

2. Public sector activities play a substantial role in the Mexican economy. In 2008, for example, they accounted for 18.4% of GDP with the following distribution among different government entities: public enterprises, 8.7%; state and municipal governments, 5.5%; federal government, 2.9%; and social security, 1.3%.

3. In 2008, the Ministry of Public Administration registered 70,230 federal public procurement contracts adding up to USD59 billion.² The acquisition of goods and services represented 65.2% of this value and the contracting of public works 34.8%.

4. Five government entities concentrate 71.8% of public federal procurement: Pemex, the state oil monopoly, contributes with 45.6%; CFE/LFC, the state electricity monopolies, with 11.3%; IMSS, the provider of health and social security services to private sector employees, with 6.6%; SCT, the ministry of transportation and communications, responsible for contracting most federal transportation and communication infrastructure, with 4.8%; and ISSSTE, the provider of health and social security services to federal government employees, with 3.6%.

5. The regulatory framework (see section II) provides for three alternative mechanisms to allocate public procurement): i) *public auctions*; ii) *auctions by invitation* with at least three invitees; and iii) *direct allocations*. In 2008, the shares of these mechanisms in the total amount contracted were: 61%, 14%, and 25%, respectively. Also, these mechanisms can be either domestic (open only to nationals) or international (open to both nationals and foreigners). In 2008, domestic procedures accounted for 65.4% of total federal government procurement.

2. Regulatory framework

6. The Mexican Constitution (article 134) states that public procurement shall assure the best available terms and conditions for the State. To accomplish this purpose it establishes, as a general rule, that public procurement shall be allocated through *public auctions* based on *sealed solvent bids* that are

¹ The data in this section was obtained from www.inegi.org.mx and www.funcionpublica.gob.mx.

² USD amounts for 2008 were obtained using an exchange rate of 11.13 pesos per dollar.

publicly opened. It also provides that secondary laws shall establish alternative procedures for circumstances where the above general rule does not ensure the best terms and conditions.

7. The Law of Public Sector Acquisitions, Leasing and Services (Acquisition Law) regulates federal procurement of goods and services, while the Law of Public Works and Related Services (Public Work Law) regulates federal public works. Procurement by state and municipal governments is regulated by corresponding local laws, except for contracts funded with federal resources, where federal laws apply.

8. Both the Acquisition and Public Work laws establish non discriminatory *public auctions* as the main mechanism to allocate contracts, but under special circumstances they allow for either *auction by invitation* with at least three invitees or *direct allocation* without the need of an auction.

9. These laws and their corresponding regulations set out the following general auction rules:

- *Lowest-price sealed-bid auctions*. Bids are secret and contracts are awarded to the lowest bids;³
- *Public opening of bids*. Bids are publicly opened (bidders, among others, can be present);
- *Multiple provision*. Contracts may be granted to two or more bidders if their bids do not differ by more than 10% with respect to the lowest bid and to the extent that it does not restrict free participation. The winning bidder would be awarded a 50% share or more of the contract and the other participants would be granted the shares previously specified in the auction rules;
- *Joint bids*. Two or more firms may offer joint bids without incorporating into a single firm;
- *Reference prices*. Government entities may set a maximum price, as a reference for bidders to offer discounts;
- *Prohibition of bids below cost or a “convenient” price level*. Entities calling auctions may dismiss tenders if they consider bids are below cost. They may also dismiss bids that are below a given percentage of the average of the main bids offered;
- *Domestic auctions*. Most public procurement contracts are reserved for nationals;
- *International auctions*. Auctions can be open to foreigners in two variants: i) international auctions under FTAs, i.e. those open only to Mexicans *and foreigners from* countries with which Mexico has FTAs with public procurement provisions; and ii) those open to all foreigners. The former are called when it is so mandated by FTAs or if no participants turned out or qualified in a previous domestic auction or their bids were not acceptable (in excess of acceptable levels). Auctions are open to all foreign bidders when no participants turned out or qualified in a previous international auction under FTA or their bids were not acceptable; or if it is so stated in foreign financing contracts granted to the federal government. In the case of the Acquisition Law domestic bids are granted a 15% preferential margin;
- *Reserves*. Under FTA provisions, the Mexican government has the right to set aside a maximum amount of public expenditures from *international auctions*.

³ In the procurement of services, multiple criteria may be used (e.g. price and quality), by applying an index where price has a 50% weight.

10. Furthermore, the Law of Transparency and Access to Public Federal Information requires federal government entities to make available to the general public detailed information related to procurement contracts. Specifically, this regulation allows any citizen to obtain general information on public procurement as well as specific information on each auction and contract, including copies of corresponding documents.

11. Finally, the Federal Law of Economic Competition (FLEC) typifies bid rigging as a *per se* prohibited anticompetitive conduct subject to a maximum sanction of USD6.6 million; recidivists are subject to a double sanction or to a sanction equivalent to 10% of their assets or annual sales.

3. Regulation, Competition and Corruption

12. Although the Constitution mandates that public procurement procedures must guarantee that the State obtains the best available terms and conditions, in practice regulations focus too much on transparency and protection of domestic suppliers and too little on assuring a competitive outcome. In general, regulations lack the incentives to promote competition. This situation, in turn, may create extraordinary rents and increase the probability of corruption.

3.1 *Barriers to Competition and Incentives to Collude*

13. Several aspects of public procurement regulation and practice introduce incentives to collude in markets that are highly concentrated, particularly where auctions are restricted to domestic suppliers:

- Full transparency of auction outcomes (winning bids and bidders) facilitates the implementation of collusive agreements, as it makes it easy to identify and punish cheaters;
- The practice of fragmented and repeated auctions facilitates market allocation, reduces incentives to deviate from collusive agreements and facilitates punishment in case of cheating;
- Multiple provision contracts may limit price competition and lay the groundwork for collusive agreements. In extreme cases, bidders can agree to present identical bids and obtain an equal share of the contract. In concentrated markets, multiple contracts should be used only if strictly necessary to secure supply. Due to these concerns, in these cases the calling entity is required take into account any recommendations issued by the competition authority;
- Joint bids may constitute a simple mechanism to collude. In concentrated markets, joint bids should be allowed only if they do not deteriorate competition: for example, if bidders with complementary capabilities join forces;
- Relatively high maximum prices may be used as an easy reference for bidders to collude on prices. Reference prices should be included only when market information is available to assure their level is not only feasible, but also competitive;
- The prohibition of bids below cost or a convenient price level may eliminate competition from low price bidders, and limits the power of auctions as an efficient mechanism to reveal market information. This prohibition entails a more stringent approach than the predatory price prohibition envisaged under the competition legislation, which is subject to a rule of reason analysis.

3.2 *Barriers to International Competition*

14. Restrictions on international auctions reduce competition and increase prices. These restrictions may explain to a great extent why international procedures only account for 34.6% of public procurement, even though a much larger portion could be supplied under competition from international suppliers. Markets for inputs, equipment, machinery, engineering and construction services, etc..., required by industries like oil, electricity, construction and health services normally have an international dimension. Although these industries account for a large majority of public procurement in Mexico, government entities only take limited advantage of international competition in these markets.

15. International auctions are the default alternative only when a FTA mandates so; even in those cases, the government has the option to reserve for nationals a portion of the associated procurement. In most cases domestic auctions are the default alternative, so procurement officials tend to choose it to avoid not only the need to justify calling for an international auction, but also pressure from domestic suppliers.

16. International competition would improve terms and conditions of public procurement even in those cases where domestic supply turns out to be the winner, since it increases incentives for domestic suppliers to present internationally competitive bids.

17. Finally, the discriminatory 15% margin in favour of nationals unnecessarily increases prices and makes it more difficult for procurement officials to justify international auctions.

3.3 *Lack of Incentives for Competitive Supply*

18. Procurement regulations and their supervision focus on auction procedures, but do not take into account the competitiveness of the outcomes. For example, procurement officials may have incentives to undertake a domestic auction even when domestic supply is highly concentrated and international supply is competitive. A domestic auction under these circumstances would increase prices above the competitive level and create extraordinary rents for domestic suppliers. However, a potential audit of this procedure would find it fully legal regardless of the uncompetitive outcome. Thus, domestic providers have incentives to lobby (through legal or illegal means) for a domestic auction, and officials may respond positively without facing much risk. On the other hand, if procurement officials open auctions to international competition and lower the price, they or their entity may not receive any recognition from doing so.

19. Similar arguments may apply for the use of multiple provision, auction fragmentation and high reference prices, especially when markets are highly concentrated. Incumbent suppliers have incentives to strongly lobby for multiple provision and against consolidating procurement contracts or aggressive reference prices, while procurement officials would not face relevant risks if they respond positively to this lobbying.

4. **Bid-Rigging Cases**

20. In spite of the general rule that mandates public tendering in government procurement, several auction rules inhibit competition and facilitate collusive conduct. Thus, in practice, government entities tend to organise frequent and fragmented auctions instead of aggregating purchases into fewer and larger contracts. In many instances, they even divide the national market and hold a series of regional auctions instead of having a single auction for the whole market. These practices turn what could be a one-shot game into a series of games, which facilitate collusive (implicit or explicit) pricing and market segmentation.

21. The following cases illustrate the issues mentioned above. These cases involve procurement contracts in the public health sector, since it is the sector the Federal Competition Commission (CFC for its initials in Spanish) has studied the most.

4.1 Surgical Sutures⁴

22. In 2000, following a complaint by Sutinmex, the CFC investigated the behaviour of bidders in nearly 90 auctions held during 1999 for the supply of different types of surgical sutures to IMSS and ISSSTE. These auctions were reserved to nationals and included multiple provision clauses.

23. The CFC identified a collusive agreement among four bidders, which was characterised by identical or similar bids in a significant number of auctions and a clear pattern of market segmentation.

4.2 X-Ray Materials⁵

24. In 2000, following a complaint by Reliable, an international supplier of x-ray materials, the CFC investigated the behaviour of bidders in nearly 250 auctions held during 1998-2000 for the supply of these materials to (mostly) IMSS. These auctions were reserved to nationals and included multiple provision clauses.

25. The CFC identified a collusive agreement among the three bidders who were the only participants (Kodak, Juama y GPP), which was characterised by identical bids and market shares in the great majority of auctions (almost 100%).

26. After these findings, IMSS opened procurement of these materials to international competition, which resulted in a dramatic reduction in prices. The following table compares some of the outcomes: in the domestic auctions, the three national suppliers presented high identical bids which assured them identical market shares; meanwhile, in the international auction, an overseas supplier won 100% of the contracts with bids that, on average, were 32.4% lower than winning bids in the domestic auctions.

**Table 1. Auction to Purchase X-Ray Material
Winning bids***

	<i>International auction</i>	<i>Domestic auctions with multiple provision</i>		
Product	<i>Reliable</i>	<i>Kodak</i>	<i>Juama</i>	<i>GPP</i>
1	100	222	222	222
2	100	124	124	124
3	100	144	144	144
4	100	123	123	123
5	100	128	128	128
<i>Average</i>	<i>100</i>	<i>148</i>		

* *Indexes relative to the lowest winning bid for each product.*

***Kodak, Juama y GPP presented identical bids for each product in 17 domestic auctions.*

⁴ CFC file: DE-003-2000.

⁵ CFC file: DE-57-2000.

4.3 *Chemical Developers for X-Ray*⁶

27. In 2001, the CFC investigated the behaviour of bidders in 64 auctions held during 1997-2001 for the supply of chemical developers for x-ray to IMSS and ISSTE. These auctions were reserved to nationals and included multiple provision clauses.

28. The CFC identified a collusive agreement between the two only bidders (Juama and GPP), which was characterised by identical bids and market shares in all auctions.

4.4 *Generic Pharmaceuticals*

29. The CFC recently developed a database with the outcomes of the auctions called by IMSS during 2003-2007 for the procurement of generic pharmaceuticals. This effort was undertaken with the purpose of evaluating the possible presence of bid-rigging in the markets involved. IMSS is by far the largest provider of health services in Mexico and accounts for about 90% of total procurement of generic pharmaceuticals by public health institutions. In 2008, for example, it spent USD 1.5 billion.⁷

30. The database includes information from approximately 400 auctions for each of nearly 250 different generic pharmaceuticals purchased by IMSS during this period. Preliminary analyses of this database provide us with many examples of competition (and possibly corruption) concerns. Some examples are presented below. For confidentiality reasons, the examples omit absolute prices and names of bidders and products.

4.4.1 *Product 1*

- Four domestic auctions during the same year; lowest-price sealed-bid; and multiple provision rules.

Table 2. Bids*

Bidder	Auction			
	1	2	3	4
A	100.13	100.13	100.09	101.51
B	100.06	100.09	NB	100.13
C	100.09	NB	100.00	100.09
D	102.2	100.06	100.13	100.06

*Lowest bid =100

Winning bid:

NB: no bid was presented

- Potential competition concerns: winning bids are practically identical among bidders; each contract is divided among three bidders; each bidder wins a share in three out of four contracts; bidders get a similar share of annual purchases; and bidders seem to take turns in participating (or winning).

⁶ CFC files: DE-10-2001.

⁷ www.imss.gob.mx.

4.4.2 *Product 2*

- Four domestic auctions during the same year; lowest-price sealed-bid; and single provision rule.

Table 3. Bids*

Bidder	Auction			
	1	2	3	4
A	Nb	nb	nb	100.21
B	105.49	nb	100.00	nb
C	100.21	100.21	nb	nb

*Lowest bid =100

Winning bid:

NB: no bid was presented

- Potential competition concerns: winning bids are practically identical among bidders; each bidder wins at least one of the four contracts; bidders get a similar share of annual purchases; and bidders seem to take turns in participating (or winning).

4.4.3 *Product 3*

- Four domestic auctions during the same year; lowest-price sealed-bid; and multiple provision rule.

Table 4. Bids*

Bidder	Auction			
	1	2	3	4
A	100.00	nb	nb	nb
B	nb	100.14	nb	100.14
C	103.79	103.79	100.00	100.00
D	nb	100.00	nb	nb
E	100.07	102.00	100.07	101.86

*Lowest bid = 100

Winning bid:

NB: no bid was presented

- Potential competition concerns: winning bids are practically identical among bidders; each contract is divided among two bidders; each bidder wins a share in at least one of the four contracts; bidders get a similar share of annual purchases; and bidders seem to take turns in participating (or winning).

4.4.4 *Product 4*

- Four domestic auctions during the same year; lowest-price sealed-bid; single provision rule.

Table 5. Bids*

Bidder	Auction			
	1	2	3	4
A	100.00	nb	nb	100.00
B	nb	100.00	100.00	nb

*Lowest bid = 100

Winning bid:

NB: no bid was presented

- Potential competition concerns: winning bids identical among bidders; each bidder wins two of the four contracts; bidders get a similar share of annual purchases; bidders seem to take turns in participating (or winning).

4.4.5 Competitive Bidding

31. In all the examples above, as well as in many others omitted because of space constraints, a more competitive design of the auctions could have increased competition and reduced the prices paid by IMSS. This hypothesis was validated by the outcomes of a more competitive procurement strategy implemented by IMSS in 2007. Specifically, between 2003 and 2006, procurement of generic pharmaceuticals was based on domestic and fragmented auctions: there was an average of nearly 100 auctions per product per year, as each consuming area (region or general hospital) held its own auctions separately and, in some instances, several times a year for the same product. Additionally, many of these auctions included multiple provision rules and relatively high reference prices. In contrast, in 2007 IMSS implemented a strategy based on using international auctions more extensively, consolidating purchases into one (or a few) annual national contract per product, including aggressively low maximum prices based on market research, and eliminating multiple provision. As a result, similarity of bids and market allocation among bidders disappeared and winning bids decreased dramatically: 18 of the 20 most important products, which represent 42% of purchases, registered an average price decrease of 20%.

32. This example illustrates the extent to which the design and implementation of truly competitive auctions can enhance the competitiveness of public procurement. The new bidding procedures clearly reduced the space for corruption, since extraordinary rents tend to disappear as prices approach their competitive levels. Unfortunately, the efforts undertaken by IMSS are still an exception and do not necessarily derive from an integral government strategy to improve the competitiveness of public procurement.

33. The new bidding procedures were developed and implemented by a few central IMSS officials, who had to overcome many obstacles. Domestic manufacturers and distributors of generic pharmaceuticals, individually or through their associations, opposed formally and informally to these changes. They presented formal complaints before the Ministry of Public Administration, responsible for supervising and auditing federal public procurement, arguing the lack of justification for international auctions, procurement consolidation and aggressive price references. They also lobbied intensively against these changes before officials of different government entities: they even approached the CFC arguing these changes were anticompetitive because they would displace or exclude domestic providers.

34. Finally, the integration and analysis of this database has provided elements not only for the design of more competitive auctions, but also to identify possible illegal bid-rigging. Base on these elements, the CFC undertook formal investigations in several markets to identify additional (direct or indirect) evidence to validate or reject this hypothesis. These investigations are currently underway.

5. Concluding Remarks

35. Competition law and policy can play a key role in promoting competitive public procurement. In achieving this goal, it also contributes to the fight against corruption by eliminating extraordinary rents that may be the source of corruptive actions. Unfortunately, in Mexico public procurement regulations and practice focus too little on promoting a more competitive environment. In most government entities the procurement strategy is characterised by unnecessary barriers to entry and fragmentation, high reference prices, multiple provision, and full transparency of auctions outcomes, among other elements. This environment restricts competition and facilitates collusion in domestically concentrated markets, which in turn creates extraordinary rents and introduces incentives for incumbents to lobby in favour of the status quo.

36. Nevertheless, the examples presented in the public health sector are important precedents in the efforts the CFC is undertaking to fight bid rigging and promote competitive outcomes in public procurement. The Commission will continue to integrate and analyse databases similar to the one on generic pharmaceuticals to identify and further investigate cases where a hypothesis of illegal collusive behaviour can be reasonably developed. The fight against bid rigging would be easier as the CFC identifies and sanctions more cases and cartel members have more incentives to apply to the leniency programme that has been recently implemented in Mexico. On the other hand, the CFC is collaborating with different government entities to promote pro-competitive procurement strategies and auction designs. In this regards it is promoting the *Guidelines for Fighting Bid rigging in Public Procurement* issued by the OECD Competition Committee in 2009. The CFC has also issued several opinions regarding the need to develop more pro-competitive public procurement regulations.