

Unclassified

DAF/COMP/GF/WD(2010)14

Organisation de Coopération et de Développement Économiques
Organisation for Economic Co-operation and Development

02-Feb-2010

English - Or. English

**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE**

Cancels & replaces the same document of 13 January 2010

Global Forum on Competition

COLLUSION AND CORRUPTION IN PUBLIC PROCUREMENT

Contribution from Korea

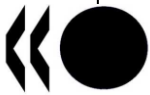
-- Session V --

This contribution is submitted by Korea under session V of the Global Forum on Competition to be held on 18 and 19 February 2010.

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JT03277921

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COLLUSION AND CORRUPTION IN PUBLIC PROCUREMENT

-- Korea --

1. **Bidding System for Government Construction Contracts: Centring around Design-Build System**

1) *Objectives of Government Construction Bid System*

1. Government construction projects pursue two objectives; saving national budget and building high-quality and safe public facilities. The two objectives, however, are contradictory¹ in nature, so it is difficult to devise a bid system that accomplishes both of the objectives. For that reason, complementary measures are taken in each bid system to satisfy the two objectives. For instance, in the lowest tender system that saves national budget and achieves the objective of price competition, review on appropriateness of bid prices is made to prevent the possible problems caused by excessively low bid prices - poor quality of the constructed facilities and the deteriorating financial condition of the construction company.

2) *Concept of Design-Build System*

2. A Construction company conducts both designing and building in a design-build project² unlike in other general government constructions where the building companies are responsible only for construction based on an architectural design plan made by the government. That is, in a bid for design-build contract, the government provides only basic plans of the bid and RFP (Reference for Proposal) and the bidders, i.e. construction companies, submit architectural drawings, application and other bidding documents. Then, finally, the awarding authority, i.e. the government, chooses a winning bidder based on review of what bidders submit.

3. Since design plan is made by construction companies themselves, the companies face more risk under design-build system. This system, however, ensures higher efficiency of the construction work by shortening the construction work period and minimising management work for the government and enabling the construction company to utilise their new technology.

3) *Design-Build & Bid Rigging*

4. Design-build is usually limited to government construction projects for facilities requiring advanced technology and construction methods such as bridges, dams, ports, railways, sewage treatment plants, waste incineration plants or CHP plants (combined heat and power plants). Therefore, a small

1 The emphasis on “budget-saving” means engaging as many companies as possible in bidding for price competition while “safe and high-quality facilities” can be better secured when just a few eligible companies participate in bidding for quality competition.

2 Design-Build is also called “turn key,” because all that an employer of the turn key project does is just turning a key to the completed building that is both designed and constructed by a contractor.

number of companies, two to five at most with high-level technology, participate in a tender for design-build contracts, which results in higher possibility of bid rigging, at least in terms of the number of bidders, than in tenders for other construction work³.

2. Conditions Facilitating Bid Rigging in Design-Build System

1) *Favourable Environment for Large Construction Companies*⁴

5. Since design-build system is usually used in large-scale construction projects⁵ for bridges, dams or ports that require enhanced technology, large construction companies with advanced equipment and labour force are in an advantageous position in a tender for design-build contracts compared to small- and mid-sized enterprises (“SMEs”). High costs incurred for a design drawing also put SMEs in a disadvantageous position, because the costs will not be reimbursed even if the company fails to win the contract⁶.

6. Generally when government prepares design-build contracts, it hires architectural design firms to make basic plans of the bid and RFP (Request for Proposal). The problem is that from the point of commissioning of the work, the information on the tender tends to be leaked out to large construction companies which have maintained close relationship with those design firms. In this case, the information helps the construction companies prepare for the tender in advance, which serves as another advantage for the large companies.

7. In short, the possibility of bid rigging in design-build contracts is heightened due to the small number of the participants and a superior position of a few large companies in labour force, technology, financial condition and information.

2) *Information Exchange between Construction Companies*

8. Employees of construction companies tend to maintain close relationship with those in other competing companies, have meetings or contact each other on a regular basis to exchange information on tenders or architectural design.

9. Sometimes information on, for example, which construction company hires which design firm to prepare for a tender is shared even before the bid announcement. This can be regarded as legitimate information exchange for sales, but lead to restricted actual competition in the bidding for the construction contract.

3 For example, at least 20~30 companies participate in a bid for construction work where the contract is awarded to the lowest bidder.

4 There is no precise definition of large construction companies, but six companies are currently regarded as large construction companies in design-build projects. (The six companies account for 30.9% of the total orders placed in 2008.)

5 In Korea, construction work of the estimated cost of 30 billion won or more is considered as a large-scale construction.

6 In fact, the government pays compensation for companies whose bids are not accepted in a tender, but the amount is far short of the cost incurred for the bidding.

3. Types of Bid Rigging Schemes in Design-Build Projects

1) *Bid Rotation*

10. Bid rotation occurs usually when several tenders for design-build projects are announced in a short period. Under the scheme, each conspirator, mostly large company, is designated to be the successful bidder on certain contracts. This way, the conspirators get their “fair share”, avoiding competition and easily securing contracts they are interested in.

11. Some companies argue bid rotation is inevitable, citing that the scheme helps maintain construction costs at an appropriate level, averting cut-throat price competition and the consequent shoddy construction. The scheme, however, apparently is a bid-rigging conspiracy in that it restricts competition among bidders in the beginning.

2) *Complementary Bidding*

12. Complementary bidding occurs usually between large companies and SMEs while bid rotation scheme is used by companies of similar sizes. In complementary bidding, a company generally of large size asks a small company to submit a cover bid to avoid a situation where its bid is unsuccessful, because no other companies participate in the bidding.

13. It could be seen that the requested company has no reason to participate in the tender considering incurring costs in design drawing, management and others. In the long run, however, participating in the bid is not an economic loss for the requested company, since compensation is made for the participation. The large company, for example, may compensate its conspirator by inviting the company to be a member of consortium bidding for other construction projects later on.

3) *Cartel in Architectural Design*

14. A successful bidder can be chosen in several ways in a tender for design-build contracts. Among them is frequently used the method of adding up the scores allocated to each category of architectural design and bid prices-60% and 40% of the total evaluation respectively in most cases- and awarding the contract to the bidder of the highest score.

15. Although rigging bid prices is the most common form of bid-rigging conspiracy, cartel on architectural design can also occur in a bid for design-build projects. That is because the rate of architectural design is higher in the evaluation than bid prices unlike the lowest tender system where the bid prices naturally become the target of collusive act. Since the ultimate goal of bid rigging is designating the winning bidder in advance or restricting competition in a tender, there is no need to limit collusion only to bid prices.

16. Cartel on architectural design can be conducted in the two ways in general.

17. One of them is designating the successful bidder in advance and ensuring the acceptance of the designated bidder by intentionally making other conspirators get poor evaluation in their design plans. In general, bidders hire architectural design firms for architectural designing since the architectural drawing has to be submitted shortly after the bidding announcement, usually in 60 or 90 days. Therefore cooperation from the hired design firms is needed to deliberately lower the score of design plans by satisfying only basic requirements or intentionally excluding necessary parts in their drawings.

18. In other cases, the bid rigging participants do not designate who will win the bid but agree on inclusion or exclusion of some parts in drawings. For example, they get together with competitors to agree

to exclude certain parts in the drawings in order to save drawing costs. This scheme is not a traditional way of bid rigging where a successful bidder is designated in advance, but it apparently constitutes cartel conduct in that competition in the architectural design is restricted in the bid. Bidders have to compete not only in bid prices but also in quality of architectural drawings.

4. Sanctions against Bid Rigging

A) *Relevant Laws*

19. The Korea Fair Trade Commission (KFTC) has the exclusive authority to regulate cartel conduct, but bid rigging conspiracy by construction companies is governed by several laws other than Monopoly Regulation and Fair Trade Act (MRFTA), the competition law enforced by the KFTC.

1) Monopoly Regulation and Fair Trade Act

20. On August 3, 2007, the KFTC revised⁷ the MRFTA to stipulate that bid-rigging conspiracy is an act of collusively determining the successful bidder, bid prices, winning bid price, bid-winning probability, architectural design or construction method or other competitive factors in a bid or auction.

21. Construction companies which engaged in bid-rigging conspiracy stipulated in the MRFTA may face corrective order, surcharges up to 10% of the contract price or imprisonment of three years or less or fines not exceeding 200 million won. Since the revision, the KFTC imposed corrective orders and surcharges on construction companies for nine bid-rigging cases. The bid-rigging case of Seoul subway extension work will be explained later.

2) Framework Act on the Construction Industry

22. In the case where a person earns illegitimate proceeds or rigs bid prices to restrict competition in a bid for construction contract, the person faces prison terms not exceeding five years or fines of 50 million won or less in accordance with Article 95 (Penalty) of the Framework Act on the Construction Industry.

23. This law, however, has limitation in that it does not regulate cartel on architectural design in a bid for design-build contract, which is sanctioned under the MRFTA.

3) Act on Contracts to Which the State is a Party

24. Article 76.1.(3) of the Enforcement Decree of the “Act on Contracts to Which the State is a Party” provides that Public Procurement Service shall prevent a company violating the regulations of the MRFTA from bidding for government construction contracts for a period it sets of one month or longer not exceeding two years in the case where the KFTC makes such request. Such restriction in bidding for future government construction contracts can be seen as severer than corrective order, surcharge or punishment since it could have significantly adverse impact on the turnover of the construction company.

⁷ It does not mean that bid rigging was not regulated before the revision. Before the revision, the KFTC had enforced against bid rigging in design-build projects by recognising bid- prices rigging as “an act of fixing, maintaining or changing prices” and cartel on architectural design as “ an act of restricting types or specifications when producing or trading goods or services.”

4) *Criminal Law*

25. According to Article 315 (Disturbance of Auctions or Tenders) of Criminal Law, a person who undermines fairness of a tender by using deceptive means or force faces imprisonment up to two years or fines not exceeding seven million won.

26. The provision of the criminal law, however, stipulates only collusive agreement leading to the actual conduct is subject to sanctions unlike the MRFTA, which recognises an agreement itself among construction companies to restrict competition as cartel conduct without the consideration whether the agreement actually result in the action.

A) Case Summary: Bid Rigging for Seoul Subway Line No.7 Extension Work

27. The case is a typical example of bid rotation for design-build projects. As Seoul city announced a basic plan on tenders for design-build contracts on six sections of work construction to extend Seoul Subway Line No.7 in December 2003, six large construction companies⁸ secretly agreed to participate in the bidding, allocating each section of work to each company of them. Their concern is that without the agreement more than one company could bid for the same section, leading to failure to win the bid. On July 11, 2007, the KFTC held a full-member committee meeting and decided to impose corrective order and surcharge of 22.1 billion won and file a complaint against the six companies with the prosecution.

5. Efforts to Eliminate Collusion in Public Procurement

1) Advocacy Targeting Private Companies

28. Bid rigging is one of typical hard-core cartel conduct. It is particularly distinguished from other cartel conspiracy in that it is considered antisocial since the conduct wastes national budget and undermines the effort to ensure safety and high quality in public facilities.

29. Considering there are quite many tenders for government construction work, the problem for the competition authority, KFTC, is that it cannot prevent the problems of budget waste and poor-quality public facilities just with detection of the cartel conduct which already happened. In that sense, the Commission recognises the need to establish a round-the-clock monitoring system to better detect the conspiracy and prevent conditions conducive to bid rigging by construction companies with systematic approach.

30. As part of such efforts to prevent collusion, the KFTC's officials attended the briefing sessions of some bids for large-scaled construction to explain to the bidders the harms of bid-rigging as well as the potential sanctions and inform them of the reward program for complainants and the leniency program.

2) Co-operation with Public Procurement Agencies

31. Besides advocacy program targeting bidders, close cooperation is needed between the KFTC, the regulator of cartel conduct, and public procurement agencies given that the latter are in direct contact with the bidders and thus in better position to prevent and detect collusion.

32. In order to train the procurement officials, the KFTC issued a Big-Rigging Prevention Manual in early 2008 that explains in easy terms about what is bid-rigging and its various kinds, what costs and harms it causes, how to detect it, etc. The Manual was distributed to major agencies in charge of procurement. To

8 They are the six large construction companies mentioned in the footnote 4.

promote the use of the manual, the KFTC held a seminar in July 2008 for the procurement officials on ‘prevention of bid-rigging’ and ‘private lawsuit for the damages caused by bid-rigging’.

33. In connection with the training, the KFTC built and operates “the Bid Rigging Indicator Analysis System” for effective and systematic detection and notification of collusion, which will be further explained below.

34. Also, the KFTC is planning to clearly stipulate in bid announcements the sanctions for collusion or in contracts the expected compensation amount (which will be 10~20% of contract prices) through close consultation with public procurement agencies.

35. Meanwhile, Public Procurement Service, the largest public orderer, operates its own unlawful bid indicator analysis system, based on which it requests the KFTC to investigate suspicious bidders, introduced fingerprint identification system for e-bidding and rewards complainants for possible collusion.

3) *Bid Rigging Indicator Analysis System (BRIAS)*

36. Bid Rigging Indicator Analysis System automatically and statistically analyses bid-rigging indicators based on data⁹ concerning bids placed by public institutions. With the data delivered online from the public institutions, the analysis system calculates the probability of bid rigging by giving weightings to various indicators like bid-winning probability, the number of bidders, bid prices, competition methods, the number of unsuccessful bids and hikes in reserve prices, transition into private contracts, etc.

37. Since October 1997, the KFTC conducted manual analysis on bidding documents obtained from some public agencies, and then in September 2006 it set up the analysis system for bid-rigging monitoring. At first, it was applied to information provided by Public Procurement Service, but the Commission had expanded the application of the system into more public bodies and all the public bodies¹⁰ started to provide information for bid-rigging indicators analysis in 2008. In particular, the KFTC secured a legal ground in the MRFTA for mandating all the public bodies to provide bid-related information for the KFTC starting from January 1, 2009.

38. The analysis system helps the KFTC better uncover bid rigging conspiracy by enabling it to monitor tenders of the public sector chronologically and conduct on-site investigation into those with significant indication of bid rigging. It also prevents national budget waste caused by bid rigging and helps establish fair competitive order. Furthermore, the system makes companies voluntarily stay away from bid rigging by sending a signal that the KFTC is keeping an eye on every bid for public work.

9 The Analysis is not limited to public construction work and includes all the G2B transactions of goods and service on the condition that bids prices of construction works is worth more than five billion won or more and bid prices for goods and service worth more than 500 million won or more.

10 The totals of 322 public agencies are currently participating including central administrative agencies, local governments and government-owned companies.