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SUMMARY OF DISCUSSION OF THE HEARING ON THE USE OF TENDERS AND AUCTIONS

15 December 2014

This document prepared by the OECD Secretariat is a detailed summary of the discussion held during Item IX of the 58th meeting of Working Party No. 2 held on 15 December 2014.

More documents related to this discussion can be found at <http://www.oecd.org/daf/competition/tenders-and-auctions.htm>

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HEARING ON THE USE OF TENDERS AND AUCTIONS

Summary of Discussion

1. This document summarises the presentations and discussions at the Hearing on Auctions and Tenders held in Paris on 15 December 2014 under Working Party No. 2 on Competition and Regulation of the OECD Competition Committee. It was chaired by Mr Alberto Heimler, Chairman of Working Party N° 2.

2. A central theme of the Hearing was the recognition that competitive mechanisms for transferring government assets and awarding concessions or procurement contracts are crucial to achieve better outcomes, but they do not, by themselves, guarantee efficient results. Attention must be paid to design and implementation.

3. An Issues Note by the Secretariat staff¹ discussed these questions in detail, touching on: awarding rules; contract design and product specification; contract duration and approaches to retendering; and tender design for minimising the risk of costly renegotiation. The main focus was the effective use of tenders in complex procurements and concessions where non-price attributes matter for a government's objectives of social welfare. In such cases trade-offs exist between price and quality, and between competition and investment incentives.

4. The presentations drew on actual experience in a variety of sectors and jurisdictions to amplify and add to the issues raised in the Note. The industries covered included mobile communications and broadcasting, capacity markets for electricity (both mainly illustrated with U.S. experience), and the transport sector (with particular reference to Italian and Romanian experiences). However, the lessons are of wider relevance, including to many other sectors. There was also an account of the new EU rules on public procurement and concessions.

5. The speakers were:

- Professor Peter Cramton, University of Maryland: “Auction design”;
- Ms Tracey Weisler, Federal Communications Commission (United States);
- Professor Marco Ponti, Polytechnic University of Milan, Italy: “The Italian transport case”;
- Ms Joanna Szychowska, European Commission, DG Internal Market and Services: “The new EU rules on public procurement and concessions – selected problems”;
- Dr Daniela Eleodor, Romanian Competition Council: “How to design tenders to achieve desired outcomes – Romania's experience”;

¹ Available at [http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=daf/comp/wp2\(2014\)15&doclang=age=en](http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=daf/comp/wp2(2014)15&doclang=age=en)

- Ms Alessandra Tonazzi, Italian Competition Authority.

1. Auctions and tenders for the award of spectrum for wireless communications and broadcasting

6. In the section of his presentation devoted to spectrum licensing, Prof. Cramton noted that the main objective of governments when auctioning spectrum is, or should be, efficiency. This means making the most effective use for society of the scarce resources involved, including addressing competition issues in the downstream markets for services to consumers. He highlighted the relevance of product specification concerning the goods being auctioned, as well as, more briefly, issues of auction design.

7. The design and specification of the licences being auctioned is an important factor for a successful outcome for the government. Bidders may potentially represent competing technological uses of the radio spectrum and have differing business plans. There is also a complex structure of complements and substitutes among different parts of the spectrum and different geographical areas, and these relationships are not necessarily the same for all bidders. The packaging of spectrum into lots for auction, in combination with the auction rules, must allow bidders to express their valuation for different combinations and aggregations of spectrum in such a way as to encourage the most socially valuable allocation to emerge. It also has important implications for auction participation and entry, and hence for the competitiveness of market outcomes. Prof. Cramton gave the example of the Thai 3G spectrum auction in 2012, in which the government split the available spectrum into three equal lots which were won by the three incumbent operators at a price barely above the reserve price. He argued that, while the outcome was not necessarily inefficient, a more disaggregated packaging scheme might have been more appropriate in this case.

8. The term of the licence being auctioned must also be determined with a view to economic efficiency, including providing appropriate incentives for investment. Licences to use the spectrum in the United States are effectively perpetual, and the situation is similar in Europe, where licences are awarded for a fixed term but with strong expectation of renewal. As Ms Weisler explained in her presentation, this treatment of renewals has been a feature of US policy since the FCC was first empowered to auction communications licences in 1993. Until 1996, there was a comparative renewal process in which rivals could petition the FCC to deny renewal of a licence, but this rarely if ever came about. Since 1996, broad provisions have applied across broadcast and wireless licences which formally create a very strong expectation of renewal. Under these provisions, renewal is granted provided only that the licensee has used the licence to provide a meaningful service and has complied with FCC rules and Communication Act requirements. Ms Weisler explained that this policy was felt to be justified by the significant investment required to provide services using spectrum, including towers, transmitters and broadcast content. Uncertainty about renewal could deter such investment if the assets involved had recoupment periods longer than the initial licence term and were specific to the service provided under the licence. If the incumbent provider lost its licence, it might not be able to recover the depreciated value of the assets as there would potentially be only one buyer for them.

9. In response to a question from the Chairman regarding whether, given the permanent nature of the licence awards, there was a secondary market for spectrum, Prof. Cramton confirmed that licences were tradable and also pointed out that the FCC had the power to relocate broadcasters from their occupied spectrum band to another equivalent band provided it met the (relatively low) cost of the relocation. He said that this aspect of contract design was intended to avoid possible hold-up of the FCC by incumbent licence holders, and was a further example of the importance of getting the specification right.

10. Prof. Cramton's presentation also touched on issues of auction design. In addition to promoting an efficient outcome, he considered that a good auction design should also provide transparency, fairness and as far as possible simplicity (while not at the cost of oversimplifying) and should prevent the possibility of collusion.

11. A good auction design should facilitate the process of price discovery so that bidders can focus their valuation efforts appropriately. It should therefore provide incentives for truthful bidding and revelation, via pricing and activity rules. He explained that the workhorse auction format used in the United States was the simultaneous ascending auction, a straightforward generalisation of the type of auction used in auction houses to the case where multiple lots are sold at once, which often performed well. Early experience in the United States had shown that bidders attempted to use bid signalling in order to communicate their intentions and pursue a collusive outcome. More recent auctions therefore do not reveal the identity of all bidders and their bids during the auction, although this information is released after the auction in the interests of transparency. A more complex format for dealing with disaggregated lots is the combinatorial clock auction. Prof. Cramton also referred to the forthcoming two-sided incentive auction in the United States, in which broadcasters will be able to offer up spectrum to be bid for by providers of mobile services who may be able to put it to more valuable use.

2. Long-term electricity markets

12. As a further example of the importance of an appropriate contract definition, Prof. Cramton cited the long-term market for electricity capacity in the US. Under the existing system, providers of generating capacity have had insufficient incentives to ensure a constant supply of electricity in stress periods. This has led to instances of acute undersupply, for example during cold weather when a surge in household demand for gas to heat homes leaves insufficient gas to run electricity generating units because their owners have not invested sufficiently in non-interruptible gas supply agreements or other solutions. Prof. Cramton explained that the state of New England has recently introduced a pay-for-performance market in which suppliers are rewarded or penalised according to their actual performance during scarcity events. Contracts for forward capacity now involve an effective obligation to supply energy during such periods, and provide appropriate incentives to invest in performance improvements.

3. Tenders for transport infrastructure and services

13. Prof. Ponti's presentation on the transport sector focused on the Italian experience and considered not only the design of contracts and award procedures, but especially wider issues concerning the regulatory context and governance.

14. Unlike wireless communications, transport technology is relatively static and the need to cater for innovation is therefore less significant. The efficient use of tenders in the transport sector instead involves a different set of complexities and challenges.

15. Prof. Ponti described Italy's prior record in awarding and administering concessions for transport infrastructure as very poor. There was inadequate use of competitive procedures to award the initial concessions. Regulation and financial control was weak. Investments were funded via major transfers from the state in the case of railways and ports (often without proper economic cost-benefit analysis or financial control of overruns), or from consumers in the case of airports and toll roads. He reported that there were attempts to extend concessions for toll highways even though the initial concessions had been very long and the concessionaires had already earned high rates of return.

16. In Italian railway services, there is limited in-the-market competition in the area of high-speed passenger services and in freight services. Most concession activity concerns local public services, which is potentially subject to competition for the market via periodic tendering. However, attempts to promote competitive tenders have failed, which Prof. Ponti attributed to two flaws of contract design. First, the role of the State as residual claimant was too large; hence, local authorities, who are both owners of the incumbent train operating companies and the bodies responsible for awarding concessions, have been able to rely on central government bailouts even in the case of extreme mismanagement. Secondly, contracts have been for large geographical areas such as an entire city or region, which is not justified by any demonstrated economies of scale but which poses a major entry barrier for potential new operators. As a result, he explained, out of 100 competitive tenders, 99 were won by the incumbent. Local services continue to operate inefficiently with very high costs of production borne by the taxpayer, which competitive tendering is failing to reduce.

17. Prof. Ponti considered that the main reason for the economic inefficiency of provision of public transport in Italy was ultimately a high level of regulatory capture, which needed to be addressed in order for more effective use of competitive awards for infrastructure and services to become possible. One strand of regulatory theory, which Prof. Ponti supported, stresses the existence of capture mechanisms whereby political decision makers have hidden agendas based on self-interested motives (such as re-election, revolving doors into industry, or in some cases outright corruption). The main remedy should involve unbundling under a stronger independent regulator. The size of contracts (as in the case of local public passenger rail) should be reduced and any demonstrated economies of scale should be set against the need to limit the political and economic clout of concessionaire companies and to prevent them being seen as “too big to fail”. The state should no longer act as residual claimant; rather, financial failure of regulated companies (which would be operating smaller-scale concessions) should be tolerated.

18. Prof. Ponti’s specific recommendations for the Italian transport sector included bringing toll highways, for which concessions have been largely amortised, back under public control, as well as using more economically reflective and efficient systems of road use pricing (such as congestion charges rather than average cost-based tolls). In contrast, he believed that rail services should be privatised in order to ensure full unbundling of service provision from the publicly owned network. In local rail services, as well as reducing the size of franchises and eliminating the judge-competitor coincidence whereby local authorities both award concessions and own the operators, he considered that contracts should be based partly on gross cost rather than on net cost.

19. In its presentation, the Romanian Competition Council (RCC) provided a case study of its involvement in the design of tenders for local public bus transport services. Under Romanian law, the provision of local public transport is the responsibility of local authorities, who may either provide the service directly via a wholly or majority-owned entity or else award a contract to a private operator on the basis of an open competitive tender. In the latter case, the winning operator has an exclusive right to operate the routes concerned, under fares regulated by the local authority and based on the operator’s costs and the volume of demand. The operator is responsible for providing and maintaining the transport vehicles and retains the passenger revenue (and therefore bears the revenue risk). Contracts are to be long enough to permit recoupment of investments but may not exceed six years in the case of bus transport.

20. Direct provision of local public transport is the most common model, but tendering of bus routes is used at county level where the creation of a coordinated transport network is essential and in small towns where the town authority does not own a transport operator.

21. The RCC became involved in the issue of tender design for bus transport through a sector inquiry into public transport services in six counties in the South East region of Romania sparked by allegations of anti-competitive practices. Although it did not uphold the allegations, it nevertheless made

recommendations concerning the design of future tenders intended to improve quality and value for money. The existing method was a beauty contest based on points for five quality criteria but excluding price. The RCC recommended that price could exert important competitive pressure on bidders and thus should be included as an additional criterion. It also concluded that the criterion of uninterrupted experience of the transport operator on the route concerned posed an unnecessary territorial barrier to entry, potentially leading to de facto long-term monopolies, and recommended that it be replaced by a criterion of experience in the field of passenger transport. Overall, the RCC emphasised to local authorities and other regulatory bodies the need to strike an appropriate balance between price and quality attributes so as to incentivise innovation and investment without restricting the access of new entrants to the market.

4. Developments in the legal and practical framework for public procurement and concessions in the EU

22. Ms Joanna Szychowska of DG Internal Market and Services gave a selective overview of the new EU directives on public procurement and concessions. These are intended to modernise the procurement framework in EU member states, provide flexibility, allow for strategic procurement, ensure soundness of procedures and better access for SMEs and cross-border entities, improve governance and increase professionalisation.

23. While praising the Issues Note, Ms Szychowska said that the notion that negotiation was in opposition to competitive procurement did not entirely reflect the EU framework. In this framework, competitive procedures can involve negotiation precisely in order to ensure that purchasers get what they want and that suppliers are able to prepare their offers, particularly in the case of complex or innovative products and services that cannot be specified in a standard template. The scope for negotiation between contracting authorities and bidders has therefore been extended in the new directives, in particular in the categories of competitive procedures with negotiation, competitive dialogue, and innovation partnerships. However, these are nevertheless competitive procedures, and are backed up by requirements for transparency and non-discrimination.

24. The EU framework, she explained, does not view price and quality objectives as being in conflict but considers that they can be taken into account via the concept of the most economically advantageous tender (MEAT). This is assessed systematically on the basis of price or cost (using a cost-effectiveness approach), the best price-quality ratio (BPQR), and, where relevant to the performance of the contract, the organisation, qualification and experience of the staff delivering it. Member States may nevertheless choose to award contracts purely on price or cost where this is appropriate.

25. The new rules also codify for the first time existing EU case law and previous decisional practice in the area of post-award contract modifications, and set out the circumstances where contracts may or may not be modified without a new procurement procedure. However, Ms Szychowska commented that they leave substantial leeway for Member States to make policy choices when implementing the rules, which would affect how effective they were in practice in preventing abuses.

26. The new directive on concessions fills a legal vacuum that has existed for 40 years, defining for the first time what constitutes a concession. The main feature of a concession is that it confers on the concessionaire the right to exploit the works or services provided in exchange for it accepting the economic risk of not recouping its investment and operating costs. It was felt very important to provide clear rules on concessions because they tend to foreclose the market to competition for a long time – 90 years in some cases. The new directives cap the duration of a concession to the time necessary for the concessionaire to have an opportunity to recoup its investment.

27. Ms Szychowska explained that the new directives were intended to improve procurement and concession practices in Member States by adding clarity to the legal framework but emphasised that the quality of implementation was vitally important. The Commission is therefore now working with Member States to assist not only with the correct legal transposition of the directives but also with broader professionalisation of public procurement practice.

28. The Chairman thanked the EU Delegation, highlighting the relevance of the complementarities between the European Union and Member States actions in the pursuit of efficiency and quality in procurement.

29. The presentation by Alessandra Tonazzi of the Italian Competition Authority (ICA) complemented Ms Szychowska's presentation by giving an account of efforts to improve procurement practices from the perspective of an individual EU member's competition agency. It also reinforced Prof. Ponti's account of procurement and concessions in Italy with respect to transport.

30. Confirming Ms Szychowska's emphasis on the importance of practical implementation, Ms Tonazzi acknowledged that public procurement in Italy was institutionally fragmented and suffered from a lack of skills and knowhow. The ICA, unlike competition agencies in some other countries, does not have supervisory powers over public procurement but has nevertheless made extensive use of its advocacy role to intervene in the design of public tenders with a view to promoting two main objectives, increasing participation and preventing collusive behaviour. It has done so in the course of 120 interventions since 1990 and by consultative advice to the central agency responsible for commissioning public services.

31. Ms Tonazzi confirmed that the prevalence of direct awards without competitive tender noted earlier by Prof. Ponti was not limited to local public transport but was characteristic of local public services generally, and reflected the fact that local authorities both awarded the contracts and owned the contracting providers. Her agency advocated the use of competitive tenders based on standard procedures, and made recommendations in the area of contract design and service specification, participation criteria, and award procedures.

32. The ICA, she said, has raised a number of concerns about contract designs in which the service specification deters participation by potential bidders. It has argued against artificial extensions or restrictions of service definitions that have this effect, and has pointed out the need to distinguish services that are a natural monopoly from those that are capable of sustaining competition. Ms Tonazzi reported that the ICA had also seen many instances of tenders where the product or service is identified with a particular brand, with the result that the tender specification directly or indirectly identified the only possible winner. The ICA advocated that the service being tendered should not be identified with a brand. In addition to the points raised by Prof. Ponti in relation to local public transport, the ICA recommended that the geographic boundary of services should not necessarily coincide with administrative boundaries but should reflect the minimum efficient scale of economic operation.

33. The ICA has also raised concerns over participation criteria that favour incumbents. It has frequently encountered participation criteria that require bidders to have previously provided services to the contracting authority. It has argued that turnover thresholds for qualification should be proportionate to the value and duration of the contract, and no higher, and that other indicators of financial stability should be used wherever possible in order not to create barriers to tender participation and market entry. For the same reason, technical requirements should be related strictly to the object of the tender, and should be transparent and communicated in advance.

34. In the area of awarding rules, the ICA's advice has been that the criterion of lowest price may be suitable where the service or product is homogenous and standardised, but that a criterion of best economic

offer may be preferable in cases where there are one or more important quality dimensions to the service. In this case, the scoring system should balance the financial bid and quality components.

35. Ms Tonazzi's final comments strongly echoed those made by Prof. Ponti and Ms Szychowska regarding the importance of the regulatory and institutional context. She said that the use of competitive tendering did not eliminate the need for regulation. It is crucial to address information problems in designing contracts and tender procedures, boosting participation, monitoring performance, and reducing incumbency advantages. Regulatory capture and "regulated capture", where the contracting authority owns the service provider, can undermine the effectiveness of competitive tendering.

36. The Chairman closed the session with some final remarks, namely noting once again that auctions, by themselves, do not guarantee efficient results and further stressing the need for preparing the markets for the auction in order to obtain favourable outcomes.