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

Working Party No. 2 on Competition and Regulation

EXECUTIVE SUMMARY OF THE HEARINGS ON THE USE OF AUCTIONS AND TENDERS

15 December 2014 & 19 June 2015

This Executive Summary by the OECD Secretariat contains the key findings from the discussions held during Item IX of the 58th meeting of Working Party No. 2 on 15 December 2014 and during Item V of the 59th meeting of Working Party No. 2 on 19 June 2015.

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

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EXECUTIVE SUMMARY

*By the Secretariat**

From the discussion at the two Hearings held by WP2 in December 2014 and June 2015, the Issues Notes, the delegates' submissions and invited presentations and papers, the following points emerge:

- (1) ***Competition is indispensable to a well-functioning system for the award of public contracts and competition advocacy has an important role to play in the design and conduct of public procurement and concessions.***

Public procurement and concessions to provide infrastructure, goods and services to or on behalf of the public account for a sizeable fraction of GDP and have significant direct and indirect effects on social welfare. Competition is indispensable to a well-functioning system for the award of such contracts. The competitive discipline of a tender can help ensure that the procuring entity achieves the lowest price or optimum value for public money. In the case of contracts which are periodically re-tendered, governments may seek to promote competition in future tenders. Public procurement and licensing also provides a strategic tool to promote competition "in the market". Finally, public procurement is increasingly being used as an instrument to achieve other strategic goals, such as promoting SMEs.

Yet the sector is also a major locus for inefficiency and bidder collusion (as well as outright corruption). Procuring entities are numerous in relation to bidders, operate under challenging timescales, and may lack expertise in competition economics. The use of competitive mechanisms at the award stage does not, by itself, ensure efficient outcomes. Poor information and contract design, bidder collusion, and lack of monitoring and enforcement can prevent the gains from competition being realised.

Competition economists therefore have an important role to play in helping procurement and concessions activity achieve its aims. Inevitably, there are trade-offs in the design of tender mechanisms, and hard and fast rules are difficult to devise given the hugely diverse kinds of goods and services procured and differences in the market structure in which suppliers operate. Nevertheless, given the size of the procurement sector and its importance for social welfare, significant gains can be made by promoting a wider understanding of key competition principles.

* This Executive Summary does not necessarily represent the consensus view of the Competition Committee. It does, however, encapsulate key points from the discussion at the roundtable, the delegates' written submissions, and the Secretariat's background paper.

- (2) ***Where non-monetary attributes are relevant to the assessment of bids, scoring auctions can help determine the optimal one, provided the scale and weighting of the non-price attribute(s) accurately reflects the contracting authority's willingness to pay for higher levels of quality. In the case of concession awards, concerns with ensuring quality and investment are often of great importance for contracting authorities and special issues arise.***

In some tenders, price is the only relevant attribute to which the government attaches weight. But non-monetary attributes ('quality') are frequently also relevant in the award of concessions and in the procurement of non-standardised goods and services. In these situations, contracting authorities face the challenge of designing auctions and tender processes that identify the optimal bid, which generally entails a trade-off between price and quality.

One approach to address the issue is the use of a scoring auction, in which the winning bid is determined as the best weighted combination of price on the one hand and scores for one or more non-price attributes on the other. Such mechanisms have strong support in theory, provided the scale and weighting of the non-price attribute(s) accurately reflects the contracting authority's willingness to pay for higher level of quality. In the recent EU Directive on public contracts,¹ the "most economically advantageous tender" may be identified as the one offering the "best price-quality ratio" (BPQR), implying a scoring rule of this sort. Alternative mechanisms to a scoring auction include price-only auctions with minimum quality thresholds, but these do not fully capture the trade-off between price and non-monetary criteria.

Scoring auctions entail more subjectivity than price-only auctions and require the use of judgment in specifying the quality attributes and the weight to attach to each one of them. This may make them less robust to favouritism and corruption than price-only awards. Further, successful enforcement of these contracts requires that performance relative to quality commitments can be monitored. The primary contractual feature for promoting quality is a scheme of penalties and rewards for poor/good performance throughout the contract period, which requires adequate monitoring.

Similar concerns arise in concessions, where investments in long term assets are often a key aspect of governments' preferences. Attaching weight to quality and investment in the awarding criteria, having performance targets, incentive/disincentive schemes and adequate monitoring can help align the incentives of the concessioner with those of the government. The duration of a concession is also a relevant consideration. Longer concessions can provide time for recoupment and raise incentives to invest, but also lead to less competitive outcomes. The competition effect resulting from periodic rebidding cannot be underestimated, but uncertainty as to the scope for recoupment may hinder incentives to invest. There are instruments that can help restore incentives to invest, such as granting some form of advantage to the incumbent in the rebidding stage, which nonetheless weakens competition in the tender, at least to some extent. Having these provisions as rewards to compliance with pre-committed performance targets can help minimise this effect and further promote incentives to invest.

¹ Directive 2014/24/EU.

- (3) ***While negotiation is the norm in the private sector, the need for transparency (among other factors) creates a strong presumption in favour of competitive tenders rather than direct negotiation with potential suppliers as a means of awarding public contracts. However, in the case of technically complex or innovative projects, consultation and negotiations at the specification and bid evaluation stages can help define the most appropriate and cost-effective solution to the contracting authority's needs.***

An increasing demand for transparency and for less subjectivity in the context of public sector procurement and concessions has created a strong presumption in favour of competitive tenders over direct negotiation with potential suppliers. However, in cases where quality attributes are not fully known at the bidding stage, or where the project is innovative and subject to a high degree of technical uncertainty, there may be a role for direct negotiations to facilitate information exchange and to help ensure that the government identifies the best specification of its needs and achieves the best outcome.

Empirical studies show that the private sector relies much more heavily on negotiations than on formal competitive mechanisms, such as tenders and auctions. One expert presenting at the Hearing suggested that there was sometimes too much emphasis on competitive award mechanisms and fixed-price contracts in the context of risky infrastructural investments, possibly because governments wish to give taxpayers the appearance of certainty over costs, even though in practice many such contracts incur cost overruns and end up being renegotiated in favour of the contractor because of the uncertainty they inevitably involve.

The 2014 EU Public Contracts Directive widens the scope for pre-contractual consultation and negotiation between contracting authorities and potential suppliers at both the specification and evaluation stages through the categories of competitive procedures with negotiation, competitive dialogue, and innovation partnerships. These are nevertheless competitive procedures, and are backed up by requirements for transparency and non-discrimination.

- (4) ***Provisions related to abnormally low tenders (ALTs) in the procurements systems aim at identifying and excluding tenders which are considered to be so low that they could indicate potential problems with the tenderer's ability to fulfil the contract. However, the reasons underlying a low bid price can be very different and not necessarily negative, and the concept of ALTs and the various methods developed for identifying them are very much ad hoc and problematic. Their use inevitably generates the risk of rejecting a genuinely competitive bid, in particular if the bidder is not provided with an opportunity to justify its bid before a decision is made. As far as possible, rather than relying on such methods, contracting authorities should seek to eliminate the scope for ill-informed or strategic underbidding in the first place by providing cost-relevant information and clear and binding contract specifications (in particular on renegotiation), backed up by credible sanctions for underperformance.***

The concept of ALTs (which comes under a variety of different names) exists in the procurement law of most of the OECD jurisdictions, as shown by the results of a survey conducted by the OECD for the June 2015 Hearing.

The causes and consequences of ALTs can be very different. An ALT may indicate that the tenderer has underestimated the costs (or overestimated the value) associated with carrying out the contract, which can lead to default, cost overruns or low quality implementation if this is awarded to the tenderer. An ALT may also be a form of strategic 'lowballing', whereby a tenderer submits an artificially low bid in order to secure a contract in the expectation of being able to renegotiate its terms ex post via hold-up or outright corruption. In both of these cases the

award of a contract to a tenderer submitting an ALT can jeopardise the ultimate cost, quality and timeliness of the contract performance, leading to social welfare losses.

In other cases, however, a low bid may result from pro-competitive factors. The tenderer may possess efficiencies, resulting for example from complementarities between the tasks of the contract and its other activities, which are being passed on to the public in the form of a low procurement price. In areas of procurement in which collusion has kept prices high in the past, a genuinely competitive bid by a new entrant may also appear 'abnormally' low.

Because of the very different implications of an ALT for contract performance, the concept of ALTs and the methods developed to identify them (which the OECD survey showed to be many and varied) all raise a number of issues. From the discussion and the experts' presentations it emerged that no method for identifying ALTs should automatically exclude a bid from the tender process without further investigation, since this could result in genuinely competitive tenders being rejected.

The OECD survey showed that pre-specified benchmarks are widely used to identify ALTs in procurement situations, although these are necessarily ad hoc. These benchmarks fall into two broad approaches, although hybrids also exist.

One approach consists in identifying ALTs based on the deviation of a bid from some statistic (such as the mean or median) relating to the distribution of the bids received. This approach includes bid average methods, which entail awarding the tender to the offer whose price is closest to the average of the bids submitted (variations exist but all sharing the same concept). While there are few empirical studies that try to assess its effectiveness, the efficiency of average bidding (which is derived from the engineering literature) has been questioned in the academic literature. The argument against it is that it forces bidders to frame their bids strategically, rather than to bid relatively straightforwardly based on their valuation of the contract, which may lead to inefficient outcomes.

Another approach which is common in procurement systems across the OECD identifies potential ALTs based on the contracting authority's cost estimate or budget for the contract rather than on the value of the other bids. This method also raises issues since the point of a competitive mechanism is to establish an efficient, market price for the procurement based on bidders' information about their own costs, which can often be expected to be superior to that of the procuring entity.

An approach to the ALT problem that does not bear the risks entailed by the two approaches discussed above aims at eliminating 'at source' the problems of possible cost underestimation or strategic low bidding through well-prepared tendering information and contract design.

In order to mitigate cost uncertainty and assist non-incumbents in forming their bids, procuring entities should be obliged to publish all relevant information and provide bidders with sufficient time to prepare their tenders. It is more questionable, however, whether the procuring entity's own cost estimates should be made public. On the one hand, if the costing is informative, this may assist bidders in formulating their own appraisals, but on the other it can lead to prices converging around that level, thus supporting collusion and preventing the tender process from acting as an efficient mechanism to elicit bidders' cost information.

Various measures exist for reducing the incentives for strategic underbidding by reducing the scope for bidders to claim subsequent cost increases. Proper tender and contract design should bind bidders to specifications that are adequate and put an onus on bidders to demonstrate their capability to undertake the project. Procedures for renegotiation should be clearly laid down in advance, but these should be limited only to cost increases due to unforeseeable circumstances. Performance security and financial guarantees, such as letters of credit and surety bonds, may also be required to deter bidders from underbidding in the hope of either renegotiating the price or defaulting on the project, as these make them incur the risk of having to carry out the project on the terms originally tendered or suffer a penalty. However, the credibility of this threat may be weakened by the fact that contracting authorities are generally reluctant to exercise it except as an extreme last resort. The threat of sanctions, such as debaring an underperforming contractor from participating in future public tenders, can also deter underbidding.

- (5) ***Specification of the object of the tender and adequate contract design are critical to successful procurement and concession awards. In addition, the division of public procurement contracts into lots must balance the pro-competitive aims of fostering competition and market entry with the potential gains from economies of scale and scope, and the need to discourage collusive market-sharing.***

The division of the object of a tender into distinct lots is used for a variety of aims, including promoting competition in the tender, fostering competition in the market, and supporting the participation of SMEs. Division of contracts into lots is encouraged in the procurement law of many jurisdictions and is mandatory in some. Nevertheless, the design of these lots is generally left at the discretion of the procuring entity, and limited guidance exists. While there is no general recipe for the appropriate division of a contract into lots given the specificities of each procurement project and the wide variety of aims (sometimes conflicting) that are pursued by procuring authorities, a number of useful considerations emerged from the discussion.

There is often a tension between competition and efficiency in the division of lots. While smaller lots are used to increase participation and to encourage the entry of smaller firms (sometimes with caps on the number of lots in which it is possible to bid or reserved lots for entrants), efficiency losses can arise if there are economies of scale or scope between lots which cannot be realised if they are awarded to different providers. The disaggregation of complementary lots can also pose the problem of ‘exposure risk’ for bidders; package bidding is one solution to this problem although it is complex for procurement practitioners to administer. One response to the OECD survey mentioned complaints by bidders that lots were aggregated unnecessarily, creating a barrier to entry. This suggests that lots should only ever be aggregated when this is justified by the existence of complementarities between them, and then only when the efficiency gains are judged to be more important than the impact on competition in the short and long run.

The packaging of lots can also affect the possibility of collusion. While it is commonly assumed that a more granular division of contracts promotes participation and therefore the intensity of competition, it can also facilitate coordinated market-sharing by bidding cartels. One suggestion for curbing collusion is to structure the lots in a way that differs from the distribution of bidders’ market shares. Because cartels typically divide up the market in proportion to the relative bargaining power of the members, this may make it harder for colluding bidders to arrive at a stable market-sharing scheme. Simultaneous rather than sequential awards may also make it harder for cartels to enforce a division of lots among themselves.