



Open Issues in Public Procurement

En rapport skriven av
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Open Issues in Public Procurement

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Preface

The Competition Authority stimulates research in the area of competition and public procurement and publishes commissioned research in order to increase interest in competition issues to academics as well as to a wide audience.

This is the background to the Competition Authority's commission to Professor Giancarlo Spagnolo at University of Rome and Stockholm School of Economics, to perform an inventory study to highlight means, measures and practices aiming at better performance in public procurement. The result is presented in the report *Open Issues in Public Procurement*.

The author himself is responsible for the conclusions and the analysis in the report.

Stockholm, October 2009

Dan Sjöblom
Director General

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1 Introduction

Thanks to the recent wave of privatization, global markets integration, and institutional and regulatory changes, the provision of Public Goods and Services is undergoing substantial changes around the world and in Sweden in particular. The Swedish Competition Authority is now in charge of the oversight of Public Procurement in Sweden, and is planning to work hard so that its role of 'advisor and watchdog' will have the most positive impact that is possible on Swedish citizens.

Public Procurement, however, is rather different than standard markets for goods and services, e.g. because of buyer power considerations, of the difficulty of finding counterfactuals to use as benchmarks for large public acquisitions, and because of the many layers of agency problems in the government with the consequent transparency, accountability and governance problems. Moreover, in some cases, in particular for large construction and innovative projects, the degree of complexity and contract incompleteness and the relevance of risk considerations make Public Procurement more similar to financial markets than to standard commodities markets.

This means that the perspective of the Swedish Competition Authority, when acting as Public Procurement advisor and watchdog, must be somewhat different and more careful than in its more standard antitrust activity to the various subtle dimensions of outcomes, including non-contractible quality provision, effects on buyers' accountability, and the management of procurement risk.

Also, Procurements are often managed by civil servants that may have a good legal background but typically have relatively low strategic and economic skills, and know therefore very little about competition and incentives. This makes the role of central advisors that explains common mistakes, publishes guidelines and examples

of tender documents and advises public buyers where needed, a really crucial one.

In this report I provide a first concise overview, based on my direct experience and current knowledge of the economics and international practice of Public Procurement and Antitrust, suggesting ways and areas in which Konkurrensverket could be more effective in achieving its statutory objectives relative to Public Procurement.

2 Procurement Legislation and Priority of Tasks

Given that Swedish administrations should follow the EU Directives on Public Procurement, which are the tasks in which an 'advisor and watchdog' is likely to impact more on the practice of Public Procurement, among for example 'advising', 'monitoring', 'auditing', 'consulting', 'advocacy', 'data collection and analysis', etc.?

2.1 Drawbacks of the Public Procurement Legislation

The EU Procurement Legislation spelled in the various Procurement Directives is complex and cumbersome in terms of the required procedures, and it is not oriented at obtaining good value for taxpayer money. The EU Legislation has been written by bureaucrats and legal experts, with an evident lack of knowledge on the economic forces and competitive dynamics crucial to efficient procurement.¹ The objectives of these directives, driven by the concerns for bureaucratic accountability typical of French administrative law and by the spirit of the Treaty of Rome, were preventing suppliers' discrimination and favouritism, either linked to bribes or corruption, or aimed at excluding foreign competitors and thereby hindering European market integration.

Good public procurers, instead, see the aim of their work as ensuring a safe, regular flow of high quality supply at good price, i.e. good value for taxpayers' money. No wonder, therefore, that public

¹ Reading the Directives makes it evident that no procurement auction or contracting expert, nor any generic industrial economist has ever been involved in the writing of any of the EU Procurement Directives that regulate public procurement markets. This even though there is fifty years of cumulative economic research on efficient procurement design, and even though several hundreds of people were involved in the drafting of such Directives.

procurers in Sweden, as in many other countries, are resisting the application of a legislation that is not designed to enhance procurement effectiveness.²

The complex and cumbersome procedures that should guarantee accountability through limited bureaucratic discretion are extremely difficult and costly to apply correctly, and lead very often to silly procedural mistakes that sometime nullify the best offer for the buying administration, imposing large costs to buyers, sellers and society (during my experience in the Italian Public Procurement Agency about one offer out of four was procedurally incorrect and had to be nullified).

Konkurrensverket is therefore in a rather difficult position. Being in a country in which civil servants are widely regarded as accountable, so that corruption is not seen as a major problem, only the openness to foreign competition and EU market integration remain as justification for such costly legislation, and as we know this is a rather weak justification.

The new EU Directives 17 and 18, 2004, have tried to increase a little the flexibility of the Public Procurement process introducing some 'new instruments' already used in countries like the UK, but the approach is still highly legalistic: the outcome/performance of the procurement does not really matter, what is crucial is that the procedures are followed accurately.

² This is not only a personal opinion. Although softened as far as possible, the 2006 Final Report on the Evaluation of the Public Procurement Directives (by Europe Economics, available at http://ec.europa.eu/internal_market/publicprocurement/docs/final_report_en.pdf) summarizes results from a survey administered to procurement agencies across Europe making it pretty clear that the general judgment of expert procurement practitioners on the EU Directives has been one of a cumbersome and costly legislation likely to make lawyers rich, judges busy, and legal and effective procurement much more difficult and costly to the taxpayer.

An example of the inefficient legalistic approach that informs also the new Directives is that of Framework Agreements. The Directives allow awarding the right to supply to one supplier only, or to more than three suppliers. That is, Framework Agreements with only one winner, that after the award will be an exclusive supplier – i.e. have a monopoly position – are admitted. Framework Agreements selecting three, five, twenty or hundred-and-thirty-five suppliers that will compete again in one form or another for public orders are admitted. However, a Framework Agreement selecting two suppliers is not allowed, for any apparent logical reason.

The problem is that in most cases the most efficient number of suppliers is two, as fifty years of empirical and theoretical economic research on the US DoD practice of *Dual Sourcing* have shown.³ The reason is of course that two suppliers allow for competition relative to one supplier, but minimize the cost of effort and investment duplication linked to more suppliers. Because of this, very often having two parallel suppliers, *Dual Sourcing*, is the optimal solution. Too bad that the 2004 EU Directives have forbidden this optimal solution in all Europe, allowing instead for all the conceivable suboptimal solutions.

Analogously, the EU Directives favour in most case open tendering for accountability and non-discrimination reasons. However, we know that in procurement of complex services open competition with no rewards for good past performance leads to poor quality and value for money. For example, Kelman (1990) examined computer procurement, comparing the government's policy with the purchasing behaviour of private firms. He noted that private firms were considerably more loyal to their past suppliers that delivered a good service. In an extensive survey, 58% of government contracts were awarded to the incumbent, compared to 78% for private firms. Moreover, 65% of government contracts were awarded to the lowest

³ See e.g. Lyons (2006) and all references therein.

bidder, compared to 41% for private contracts. The government contracts awarded competitively rated particularly badly on “keeping promises” and “sticking to the contracted delivery schedule”. For example, Kelman reported that vendors held up the government by withdrawing key personnel, investing in fewer quality and on-site personnel and providing poor advice and few creative ideas.

Indeed, when Kelman became responsible for Public Procurement in the US under the Clinton administration, he started a reform process towards increased flexibility and performance orientation, increasing the value of past performance indicators and reducing legalistic procedural requirements that kept the transaction costs of procurement very high. This movement of Public Procurement towards private business practice and away from a legalistic-procedural approach such that of EU Directives is still going on in the US.⁴

2.2 Watchdog’s Tasks Likely to Have Highest Impact

Given that most public acquisition agencies are likely to be aware of the high procedural and efficiency costs of implementing the rigid and cumbersome legislation linked to EU Directive, the task of Konkurrensverket will be a daunting one. From my own experience, the tasks in which an ‘advisor and watchdog’ is likely to impact more in facilitating the process of learning to survive respecting EU Public Procurement legislation without losing too much value for money are the following:

⁴ As testified, for example, by the 2007 *Report of the Acquisition Advisory Panel to the Office of Federal Procurement Policy and the United States Congress*.

- a) **'Advising', in a pro-active sense.** *Advising Procurement authorities on how to avoid the most common mistakes made in the writing of tender documents according to Public Procurement legislation; about designing scoring rules and quality requirements that appropriately reflect the buyer needs, avoiding the several misleading scoring rules that we inherited from past practice; in ensuring consistency between scoring rules or minimal requirements and the structure of Service Level Agreements and related contractual penalties for violations in the relative supply contract; in ensuring that the procurement contract is sufficiently simple to be manageable for the personnel of the administration that will administer it. These are very complex tasks for the typically low skills public buyers. A very useful thing that a central oversight agency could do is to publish examples of standardized tender documents that administrations could copy and adapt for their own procurement (and possibly arrange for a phone number where to answer questions about such standard documents), put it is clear that KKV does not have the resources for this kind of support. It could however provide economic advice to other less economic-oriented organizations that do it*
- b) **'Advocacy' for:** *(i) Simplification in all possible directions of the EU Directive-based Procurement Legislation; (ii) an application and interpretation as flexible and as outcome-oriented (rather than procedure-oriented) as possible, also with courts, to avoid that litigation on complicated and useless formal/procedural details starts driving Public Procurement, rather than value for tax-payer money, the substance; and (iii) advocacy also for the creation of certified training courses in procurement where local procurers are trained and helped to find a manageable way to respect the procurement legislation while at the same time limiting bureaucratic and efficiency losses.*

- c) **'Monitoring on performance'**, *i.e. substance rather than form: monitoring and auditing should not, in my view, focus too much on the cumbersome and often useless formal/procedural details, though it is clearly easier to monitor formal procedures than substantial outcomes. Competition is not a good procedure by itself, it is not an end, it is a mean, often a good mean to obtain value for money, tax-payers' money in the case of procurement. Hence, an economically skilled agency as KKV should try focusing its monitoring on the outcome of the procurement, in terms of active participation and non-exclusion of competitors, but above all in terms of market benchmarking on the value for money delivered by different procurements. For this to be viable it is of course crucial the organization of a well structured and comprehensive process of data collection and analysis. Note that partial solutions may do more harm than good here. For example, benchmarking by comparing prices across different acquisitions is at best useless but most likely misleading, if one does not control appropriately for differences in the many quality dimensions of procured good and services; controlling for differences in contractually required quality is useless if not misleading if one does not know how contracts were managed, whether the stated quality was actually delivered ex post or not.*

Box 1. Most Likely Effective Tasks

- a) **'Advising', in a pro-active sense:** Advising Procurement authorities on how to avoid the most common mistakes made in the writing of tender documents; about designing scoring rules and quality requirements that appropriately reflect the buyer needs and avoiding the misleading scoring rules that we inherit from past practice; in ensuring consistency between scoring rules or minimal requirements and the structure of Service Level Agreements and related contractual penalties for violations in the relative supply contract; in ensuring that the procurement contract is sufficiently simple to be manageable for the personnel of the administration that will administer it.
- b) **'Advocacy' for:** (i) Simplification in all possible directions of the EU Directive-based Procurement Legislation; (ii) an application and interpretation as flexible and as outcome-oriented (rather than procedure-oriented) as possible, also with courts, to avoid that litigation on complicated and useless formal/procedural details starts driving Public Procurement, rather than value for tax-payer money, the substance; and (iii) advocacy also for the creation of certified training courses in procurement.
- c) **'Monitoring on performance':** monitoring and auditing, which should not focus on the formal/procedural details, but should focus on the outcome of the procurement, in terms of active participation and non-exclusion of competitors, but above all in terms of market benchmarking on the value for money delivered by different procurements. For this to be viable it is of course crucial the organization of a well structured and comprehensive process of data collection and analysis.

3 Public Procurement and Competition Policy

Which are the main 'open issues' - from a competition policy, an efficient procurement, and a public accountability perspective – raised by the choice between standard competitive procurement, customer choice models, Public-Private Partnerships, etc.?

3.1 Cartels

It is well known, at least since Stigler (1964), that Public Procurement is particularly prone to generate bid rigging cartels among suppliers, both because of the repetitive nature of public acquisitions, and because of the disclosure rules that makes it very easy for cartel members to detect deviations from collusive strategies and punish them.⁵ There is a large literature on how to fight cartels that applies more or less unchanged to Procurement, and several screens and check lists have been developed to help procurers identify likely collusive schemes.⁶ Most of this stuff is standard and well known, not very interesting for a report on the specificities of Public Procurement.⁷ However, some questions regarding cartels in procurement have not received the due attention, and are currently open issues for procurement agencies and competition authorities.

⁵ Stigler pointed out that "the system of sealed bids, publicly opened with full identification of each bidder's price and specification, is the ideal instrument for the detection of price cutting."

⁶ See e.g. "Fighting Cartels in Public Procurement", OECD Policy Brief 2008, available at <http://www.oecd.org/dataoecd/45/63/41505296.pdf>; and the OECD "Guidelines for Fighting Bid Rigging in Public Procurement" available at <http://www.oecd.org/dataoecd/27/19/42851044.pdf>.

⁷ See Albano et al. (2006) and Marshall et al. (2006) for overviews on policies to deter cartels in procurement, and Anderson and Kovacic (2008) for an appraisal with a joint Public Procurement and international trade perspective.

Suppose, for example, that a procurement agency realizes that a group of suppliers are colluding, or have been colluding at the award stage, and that the winner of the contract, the current contractor, was part of the agreement. If the procurement agency notifies the suspect to the KKV, the KKV may have to open an investigation and perhaps the procurement contract must be suspended. However, for many goods and services continuity of procurement, supply assurance, is crucial, much more than price and the damages from an interruption in supply can be enormous. What are then the incentives to report a suspected cartel for the procurement agency, apart from the moral and legal obligation?

And what about remedies? Should a procurement agency ask for damages from suppliers when the presence of a ring is ascertained by a court? More importantly, In particular, the Public Procurement Directives list a number of cases where contracting authorities should exclude candidate contractors from the selection process, for example when these have been subject of a conviction for fraud, corruption or money laundering (Article 45(1) of Directive 2004/18/EC), or in cases of bankruptcy, offences relative to professional conduct, non-payment of taxes or social security contributions, etc. (Article 45(2)). Shouldn't as a consequence procurement agencies also penalize or exclude for one or more future procurements a group of suppliers that violated antitrust law in the past by forming a collusive ring? If not, why not, given that fraud and analogous white collar crimes are treated that way? If yes, how can this be implemented when most or all eligible suppliers where part of the ring? These are important open issues that need to be clarified, studying them theoretically and experimentally, if possible.

3.2 Joint Bidding

Another open issue closely related to those just mentioned is how to regulate the various forms of joint bidding that firms often put together, from very short run ‘temporary associations’ to more long term consortia and joint ventures. Different forms of joint bidding can generate substantial efficiencies through cost and skill synergies, information sharing, efficient capacity allocation and risk management. But joint bidding may also be abused to reduce the number of independent (real or potential) competitors or—even worse—to facilitate or enforce collusion among them.

The regulation of joint bidding varies wildly across Europe, and it does not appear to follow any consistent set of economic principles. In a recent study we have first documented this heterogeneity in regulation through a survey.⁸ Then, borrowing from the theories of joint bidding in auctions and of horizontal mergers and joint ventures in oligopoly, we have reviewed the basic economics of bidding consortia and of the effects that these can have in terms of bidding competition, coordination among firms, risk management, other synergies and entry, also trying to assess the relative degrees of restrictiveness of several practical criteria that could be adopted to create consistent regulatory requirements for bidding consortia in Public Procurement. The conclusion that we have drawn in that paper and that remains valid for the Swedish case, is that there is an urgent need for further theoretical, empirical and experimental research on this important topic: if and how to regulate joint bidding in different Public Procurements remains an open issue both from a procurement efficiency and competition policy perspective .

⁸ See Albano, Spagnolo and Zanza (2009).

3.3 Scoring rules

Competitive procurements achieve in general more efficient outcomes when tenders are evaluated according to the economically most advantageous offer. This is true as long as bidders behave competitively and the procurement agency is able to draw a scoring rule that appropriately represents its evaluation of the different quality dimensions of the supply relative to price discounts, and that is fully understood by bidders.⁹

Many different scoring rules are observed in reality, very often not based on proper economic grounds. In particular, scoring rules that are 'interdependent', i.e. where a bid's score and ranking depends on the other submitted bids, are often used in Public Procurement practice. Whether they are used in lowest price or economically most advantageous offer procurements, *interdependent* scoring rules present several drawbacks, among which that of being in general easily manipulated by groups of colluding suppliers, who can coordinate their offers to influence the scoring rule and exclude potential entrants or 'maverick' bidders expected to behave competitively not being part of the ring.

A well know Italian example is that of the 2002 'Restaurant Tickets' (Buoni Pasto) procurement, in which a group of coordinated suppliers split the lots among themselves, coordinating their offers on each lot in such a way that they could exclude an independent bidder in each lot, so that that the collusive bidder that should win that lot would indeed win it. In general, therefore, it is important to avoid interdependent scoring rules.

Particularly dangerous is a particular class of interdependent scoring rules, called 'Bid Average Methods' (BAMs), that are often use in construction procurement. Scoring rules in this class have in

⁹ See Dini, Pacini and Valletti (2006) for an introduction.

common the property of rewarding offers that are closer to some average of the bids submitted. Some of them eliminate the best and worst $x\%$ of the offers (cut the 'wings' of the received bid distribution) before calculating the average and awarding the contract to the bid closest to the average among the bids that are not excluded. These scoring rules are very easily manipulated by the participation of 'shell bidders' that place offers only to influence the bid average, and make collusive agreements very stable by penalizing aggressive bids of firms undercutting the agreed cartel price with a lower score (because the undercutting bid differs a lot from the average bid, strongly influenced by colluding and shell bidders).¹⁰

Recent theoretical and empirical work suggests that this kind of scoring rule may have a role in curbing too aggressive bids when the common component of a procurement contract is dominant and firms have a low cost of going bankrupt if they overbid.¹¹ Still, because BAMs have the potential to foster collusion and to undermine the outcome of the procurement, KKV should closely monitor and, if possible, limit their use to those extreme situations.

However, note that all interdependent scoring rules can be manipulated, not only BAMs. In the example of the Italian "Restaurant Tickets" case mentioned at § 3.3.3 the evaluation of the economic offer followed a standard scoring function of the type Minimum Price/Offered Price, hence all types of interdependent scoring rules are open to this problem.

Interdependent scoring rules appeared to have the advantage that to be constructed and used no reserve price was needed, so they could be useful in new tenders for innovative or yet inexistent products/bundle of products for which it could be difficult to

¹⁰ See Bianchi, Albano, and Spagnolo (2007).

¹¹ See DeCarolis (2009).

establish a correct public reserve price, necessary to calculate the hard to manipulate linear scoring rules.¹²

However, independent scoring rules not using the reserve price can easily be constructed, and the new EU Directives always require determining a reserve price, hence there is no reason left to use interdependent scoring rules apart from the custom of past practice and ignorance/inability to apply linear ones.

3.4 Customer choice models

These models are especially useful to maintain hard to contract quality levels chosen after the award of the procurement contract, as even though contractors are chosen, they keep them competing for customers also after the award of the contract. However, these systems only work if consumers are sufficiently informed and mobile, which we know from UK experience that it is very often not the case.

If the customer choice model is added to a well designed procurement strategy, customer choice systems in public service provision should not create special problems, neither from an antitrust perspective nor from a procurement one. If the only dimension they differ from standard competitive procurements is in the fact that they induce additional ex post competition, as long as competition is appropriate they tend to further improve delivered quality.

If instead customer choice models are introduced instead of a well design strategy for the selection and management of contractors, delegating to uninformed customers the role of a skilled public

¹² The advantages and efficient use of linear scoring rules are described in detail in Dini, Pacini and Valletti (2006).

procurer, then these models may lead to very poor outcomes. As stated above, few final customers are willing to collect information, compare performance, and switch suppliers, in practically any type of provision, and firms are very well aware of it. Low customer mobility ensures that a customer choice model can complement effective procurement strategies, but never replace it.

3.5 Public-Private Partnerships

This new form of public good provision is characterized by the bundling of financing, asset ownership and service provision. Many benefits have been highlighted for this form of procurement, particularly in terms of increased efficiency and shorter delivery time.¹³ The main and often overlooked competition policy concern they generate is that typical of the large size of the projects and the transaction costs of bundling: very few players form in these markets, even in large countries able to face the uncertainty linked to such large projects, and these few large players interact repeatedly on the different PPPs. Maintaining an healthy degree of competition becomes therefore problematic.

¹³ See Iossa and Martimort (2008) for an overview.

4 Other Problems with the “New Instruments”

Which are the main ‘open issues’ - from a competition policy, an efficient procurement, and a public accountability perspective – raised by the 2004 EU Directives 17 and 18 and the way they have been incorporated in the Swedish legal system, with particular attention to the novel instruments they introduced?

EU 2004 Directives 17 and 18 introduced, among other innovations, the four ‘new’ acquisition instruments, Framework Agreements, Dynamic Acquisition Systems, Electronic Auctions, and Competitive Dialogue, partly inspired by the existing practice in some European countries, but not at all by existing knowledge in efficient procurement design. The fact that these instruments are not informed by current knowledge on efficient procurement design is reflected by a number of important unresolved issues left open by the legislation.

For reasons of space and economy of this first report, we will only briefly deal with what I regard as the three most important open issues about Framework Agreements (FAs), probably the ‘new instrument’ that will be used most intensively in Sweden and in other European countries in the next few years. The many other open issues relative to FAs and to the other ‘new’ instruments will be dealt in future reports, if any will be requested.

In what follows I will assume that the reader is already familiar with the four types of FAs prescribed by the 2004 EU Directives. To remind the reader, the FAs described in the Directives differ along two dimensions:

- (i) whether contracts are complete, so that no further mini-competition is required/admitted between contractors selected at the beginning, or incomplete, so that a second (possibly) competitive phase is required where purchasing administrations can complete the order;
- (ii) whether one or more than three contractors are awarded the right to supply during the period of validity FAs.

There are several positive things achieved by the new Directive with respect to FAs. In particular, it regulated their maximal duration that - if excessive - could generate too much lock-in and thereby reduce present and future competition. Indeed, the risk that FAs-like arrangements in which a closed list of eligible suppliers for the recurrent need of some acquiring administration is formed and lasts a very long time, excluding several entering (foreign) suppliers, was at the heart of the Monti-led European Commission's competition enforcement action against the United Kingdom for its use of Framework Agreements in Public Procurement in the mid 90s.

Analogous concerns, together with additional concerns for reduced accountability and low value for money linked to the abuse of centrally arranged contracts, were raised by some observers with respect to the current use of IDIQs, the US counterpart of FAs, as in the US these types of framework contracts are not as closely regulated as are FAs in the 2004 EU Directives.¹⁴

¹⁴ IDIQs stands for Indefinite Duration Indefinite Quantities Agreements. See Yukins (2008) for a concise description of Monti's competition enforcement initiative against the use of FAs in the UK in the '90s which was probably the cause why these instruments were finally regulated by the 2004 Directive; for an historical and comparative account for these analogous forms of centrally coordinated procurement (FAs in Europe, IDIQs in the US); and for a critical appraisal of some possible abuses in the current use of IDIQs in the US.

Still, several important questions remain open with respect to European FAs as regulated by the EU Directive 18, 2004. These are in my view the three most important ones KKV should without doubts deal with.

First, as we already mentioned in the introduction, the fact that FAs with a single operator (that is, with post-award monopoly) are admitted, that FAs with three or many more operators are admitted, but that FAs with two operators are not, does not make any economic or logical sense (though I cannot exclude that for some odd reason it could have some 'legal sense'). Dual Sourcing, i.e. having two operators admitted to supply within a FA, is likely to be optimal much more often than having three, four, five or thirty-eight suppliers, as it implies less duplication of fixed costs than any larger number of operators, while still differing crucially from the case of a single operator because it induces post-award duopolistic competition rather than full post-award monopoly lock-in. If the European Commission, for one reason or another, ends up committing an obvious, blatant mistake, like this one of forbidding Dual Sourcing, it is not obvious that all the Member States should follow the same mistake. Sweden could advocate correction; it could start an interrogation to the European Commission to get the allowance to use also Dual Sourcing, and in the meanwhile could write its own national Legislation correctly, admitting also FAs with two operators.

Second, the case of incomplete FAs with only one supplier (Framework Agreements *stricto sensu* that do not establish all the terms concluded with a single economic operator) is, to be generous, highly suspicious, both from a competitive and a procurement efficiency perspective. After the first round of competition for the selection of the operators that will serve for the duration of a FA, an incomplete FA requires a second round of competition each time that an administration wants to place an order, second round in which the contract is completed in all dimensions with the specific

requirements preferred by the administration placing the order. But if only one operator is chosen in the first competitive round, at the moment of the placement of orders and completion of contract this selected contractor will be in a monopoly position, and is therefore likely to exploit such position to impose on ordering administrations punitive conditions on the incomplete parts of the contract. In other words: Allowing for FAs with incomplete contracts and only one contractor does not make any sense from a competitive and procurement efficiency point of view (though I cannot exclude that for some odd reason it could have some legal sense). KKV could, and in my view should advocate disallowing this possibility in Sweden.

Third, how should contracts be allocated among multiple operators in the case of FAs that establish all the terms and are concluded with multiple economic operators (multiple framework contracts)? And, are operators that were awarded the FA obliged to serve administrations requiring supply? These two questions are important and strictly related.

Quoting the EC Explanatory Note on FAs – Classic Directive¹⁵: *“The choice between the different economic operators for the execution of a specific order is, on the other hand, not explicitly regulated by the Directive. Consequently, this choice may be made simply by complying with the basic principles, cf. Article 2. One way of doing this is the “cascade” method, i.e. firstly contacting the economic operator whose tender for the award of a framework agreement establishing all the terms (framework contract) was considered the best and turning to the second one where the first one is not capable of or interested in providing the goods, services or works in question.”* (p. 8).

¹⁵Available at http://ec.europa.eu/internal_market/publicprocurement/docs/explan-notes/classic-dir-framework_en.pdf

The answer to the first question proposed by the EC, the ‘cascade’ criterion according to which buyers should start requiring supply to the operator that ranked first in the initial competition for the selection of the FA’s contractors, and turning to the second if the first one is not capable of or interested in providing the good implies that the EC assumes that operators that were awarded an FA are not obliged to supply.

On the other hand, the same EC Note states before that: *“Furthermore, the answer to the question whether an economic operator who is party to a framework agreement (single or multiple) that establishes all the terms is obliged to deliver the agreed goods, work or services under the terms established and whether the contracting authority may possibly compel him to do so also depends on national law,...”* (p. 3-4). This suggests that national law can require an operator that bids for a FA and wins the award to perform according to his bid. Indeed, this is what happens in standard competitive procurements, where bidders are required to provide guarantees that ensure that their bids are ‘serious’ commitments to supply the stated conditions, and where the winning bidder is required to provide further financial guarantees to ensure continued and satisfactory provision of contracted supply.

Lack of obligation to supply may remove incentives to bid seriously at the initial stage, foster distortive shill bidding, disrupt supply certainty by interrupting supply flows when administrations relied on the presence of continued supply at the agreed conditions, etc. Also, a lack of obligation to supply makes it unclear how should participation requirements be established for the initial competitive selection of FAs’ operators. Suppose, for example, that the FA should cover a demand for 10 units in the time frame of the FA, and that it is decided that the number of eligible operators that will serve the FA is five. If there is an obligation to supply, then clearly it will be sufficient that each bidder is able to supply at least 2 units in the time frame of the FA, so capacity based participation requirements can be as low as 2. Suppose instead that winning operators are not obliged

to supply. Then if five operators with capacity 2 are selected and two of them for some reasons refuse to supply, the FA will only be able to cover 60% of the needed supply, and supply uncertainty will create additional costs, sometimes large, to administrations that relied on the FA.

Related problems emerge with the new method of calculating the financial guarantees that suppliers should provide when starting to serve a FA. According to these new methods, starting from discounts larger than 10% on the starting value of the contract, the size of the financial guarantees should grow proportionally to the growth of the percent discount offered. Also, it is not clear whether, according to the Directive, the guarantee should be paid immediately by all winners of the FA, whether it should cover all the FA supply or only a fraction proportional to each firm supply plan, the fraction of the total supply that a FA would have to cover.

Box 2. Framework Agreements

- d)** FAs with incomplete contracts and only one contractor do not make any sense from a competitive and procurement efficiency point of view (though I cannot exclude that for some odd reason it could have some legal sense) and should not be used.
- e)** Sweden could advocate correction of EU Directive to admit FAs with 2 awards, similar to Dual Sourcing for incomplete FAs; it could start an interrogation to the European Commission to get the allowance to use also Dual Sourcing, and in the meanwhile could write its own national Legislation correctly, admitting also FAs with two operators.
- f)** Lack of obligation to supply may remove incentives to bid seriously at the initial stage, foster distortive shill bidding, disrupt supply certainty by interrupting supply flows when administrations relied on the presence of continued supply at the agreed conditions, etc. Require that bids are binding offers.

5 **Opening up Procurement to Smaller Firms**

Which appear to be the more economically sound and the more practical instruments to open up procurement to medium and small size firms without reducing the quality of service or increasing the risk of disruption of service for citizens?

The US experience leads on how to involve small business in Public Procurement. In the US, the practice more widely used to stimulate participation of small business to Public Procurement has been the Small Business Set-Aside Program, by which contracting officers, in coordination with the Small Business Administration, can reserve some acquisitions or parts of some acquisitions exclusively to small businesses. Other US Small Business Programs give an advantage, typically of 5%, to bidders qualifying as small businesses.

To my knowledge, there has not been a well crafted and general policy evaluation study of this program. Some recent academic studies of bid preferences in highway construction projects suggest that bid preferences programs for small businesses may be a valid instrument. In particular, while a first study by Marion (2007) suggested that these programs may be rather expensive in terms of reduced participation by the typically more efficient large firms, more recent evidence by Krasnokutskaya and Seim (2007) suggest instead that the cost of these programs for the government is quite low, that these programs are quite effective in increasing small business participation to Public Procurement and, of particular interest for us in Europe, that the main barrier for small businesses are bidding costs, i.e. the costs of participating to procurement tenders.

Besides these programs, the US Small Business Act poses constraints to the trend towards consolidating and bundling previously separate supply contracts into single larger contracts. Any such form of consolidation must be evaluated and can be adopted only if substantial savings are expected. Also, the Small Business Administration offers direct support to small business both in terms of training and legal/administrative help for tender participation.¹⁶

In Europe programs like set-asides and bid preferences are not viable because of concerns for exclusion of foreign competitors built in the European legislation based on the Treaty of Rome. However, following the issuance of the European Small Business Act in June 2006, the European commission published a “Code of Best Practices” for facilitating access to Small and Medium Enterprises (SMEs) to Public Procurement contracts. The code summarizes a number of somewhat obvious but still important and often disregarded precautions that procuring agencies could/should take to avoid unduly excluding potentially efficient but small suppliers from the competition.¹⁷ The focus of the Best Practices is on overcoming difficulties relating to the size of contracts (increasing the number of lots and reducing their size, using framework contracts with multiple operators, facilitating joint bidding and subcontracting), on facilitating access to and quality of relevant information, limiting qualification levels and financial requirements and alleviating the administrative burden.

¹⁶ See <http://www.sba.gov/> for an overview of the historical development and current Small Business Policies and Legislation in the US.

¹⁷ See the EUROPEAN CODE OF BEST PRACTICES FACILITATING ACCESS BY SMES TO PUBLIC PROCUREMENT CONTRACTS, Commission Staff Working Document SEC (2008) 2193, available at http://ec.europa.eu/internal_market/publicprocurement/docs/sme_code_of_best_practices_en.pdf.

However, it is clear that the large fixed costs of bidding induced by the complex legal procedures required by the Procurement Legislation based on EU Directives will always hinder small businesses, who cannot afford the costly legal and administrative capabilities that large firms can thanks to the much larger turnover on which they can spread their fixed costs. In my view, therefore, the only way to significantly reduce this heavy handicap of SMEs is to arrange a large support network that offers direct and free legal and administrative assistance in the preparation of each bid to SMEs, much like some branches of the SBA in the US claim to do.

Also, increasing the number of lots and limiting their size may be a very costly procedure when economies of scale or other forms of positive complementarities are present, because large firms cannot be sure to win more than one lot, nor about which combination of lots they are likely to win, preventing them to exploit complementarities. For example, if lots are geographical and transport costs are very important, a very efficient firm with economy of scales in serving the south region of a country would risk winning one lot in the north, one in the east and one in the west. This is called the 'exposure problem', as in the presence of complementarities between lots a supplier is exposed to the risk of not winning the complement lots, and will therefore bid much less aggressively.

Reducing fixed costs of participation to let SMEs participate to procurement auctions is of course certainly positive. Reducing much the size of lots may instead result in large inefficiencies in all those industries in which there are economies of scale or scope, where a large number of small lots would prevent the exploitation of complementarities and allocate production unnaturally to inefficient small firms in industries where the natural competitive equilibrium would require a large firm size.

Because we are not sure about the amount of gains from complementarities, and because in some industries SMEs have other advantages linked to their flexibility, the optimal solution is to divide supply in multiple small lots and then allow for package bidding, i.e. for conditional offers valid only if all lots included in the package offer are awarded. Small lots with package bidding, i.e. combinatorial procurement auction are the optimal solution to reduce the 'contract size' problem for SMEs without creating huge distortions to the market, and have been used in Italy for standard procurement, in UK for allocation of Bus traits, and in many other public auctions.¹⁸ The fact that the EU Code of Best Practices does not even mention the problem generated by neither the exposure effects, nor the Italian and UK experience with package bidding exemplifies the distance still existing between European Regulators and Lawmakers and good procurement knowledge and practice.

¹⁸ See Dimitri et al. (2006) for an accessible introduction to combinatorial auctions in Public Procurement.

6 Contracts Awarded Without Notice

It seems that many long-term contracts are still in place between Swedish administrations and supplying firms that were awarded in the past without any form of publicity or competition. Also, it appears that several local authorities are still directly awarding contracts to some firms without any form of public notice and competitive tendering. What to do about that?

Unfortunately from my conversations with KKV's legal experts it appears that - although illegally awarded according to current legislation - these contracts are not void under current Swedish legislation, though new legislation is going to be passed soon that will likely change the situation. Potential competitors could already sue if they get to know about the illegal award per time, and have the award cancelled and re-awarded openly. However, it is hard to see how they should know given that administrations will keep this award non-public. Moreover, it looks like it would be difficult to obtain damages; hence the incentives to sue are low or inexistent.

What KKV could do about these contracts is more a legal than an economic issue. Once the content of the new legislation becomes more clear, KKV will know what legal steps it will be able to take with it, and perhaps it will then be useful to send a notice to all public buyers (and perhaps advertise it in official procurement journals) that as soon as the legislation is in place it will act in a certain way to obtain remedies and make illegally awarded contracts void. But before that it seems KKV can do little about it but collect all available information about them.

One thing KKV could perhaps do in terms of advocacy is to push for introduction of a whistleblower scheme similar to the US False Claim Act which employees that report illegal behaviour in procurement are protected in terms of their employment and entitled to a fraction

of all damage payments paid by wrongdoers, but this would only work if the size of damage payments and fines for such illegal behaviour are reasonably high, which will also depend on the legislation that will be passed, besides the Swedish legal tradition.

7 **Special Areas Where Open Competition May not Help**

Which are the areas in which KKV must be particularly careful not to apply standard competitive arguments developed for homogeneous-good complete contracting markets?

Where contracts are highly incomplete, either because user needs are likely to change in important and unpredictable ways within the time span covered by the contract, so that flexibility and adaptation are crucial (as, e.g. in R&D, Construction, IT Development, etc.); or because crucial dimension of the supply are hard to contract and monitor by a court, as when they are linked to the quality of human capital (as in Consulting and other complex services), the object of competition is not well defined.

In these situations competition may not work in the way desired, as aggressive offers on contractible dimensions of the supply may lead to award contracts to suppliers unwilling or unable to supply the desired quality levels on the non-contractible dimension which are the crucial ones (see e.g. Manelli and Vincent 1995, Bajari and Tadelis 2006). These are situations analogous to financial markets, where the quality may depend on price, and low price competition may destroy value for money.

Similar and as common situations, are those that resemble markets for 'experts' or for 'experience goods', supplier selection through open competitive procurement that necessarily rank offers on contractible dimensions may do more harm than good. Reputational forces are crucial to obtain value for money, and competitive procurement is hardly compatible with them (see Calzolari and Spagnolo 2009).

Reputational forces can be allowed to work in Public Procurement by making future awards conditional of good performance today, but the measure of good performance must include ex-post subjective evaluation by contract managers and, above all, final users. These kinds of 'reputation systems' replicate what Vendor Rating evaluations do in private procurement, need to be properly designed and implemented but are entirely feasible for public acquisitions. Their design and implementation has been discussed in detail with a Public Procurement perspective in Dini and Spagnolo (2005) and Dellarocas et al. (2006).

In the US there has been an effort in the last decades to create a system of ex post evaluation of suppliers, including subjective elements, and a national database collecting and summarizing in electronic form these evaluations for each past supplier to be used for selection in future procurements. The Past Performance Handbook (Cole and Beausoleil 2002), which is based on the experience of the US DoD, suggests to allocate to past performance information at least 25% of the score in any further competitive procurement.

In Europe, procurement legislation has again taken the opposite direction, stressing that in Public Procurement only the offers can be evaluated and not the offerer, leaving a role for penalizing bad performance in the past only to qualification criteria. However, also qualification criteria are limited to verifiable information, so that it may become impossible to penalize or exclude past suppliers that performed poorly, unless they committed serious contractual violations. The logic of this European legislation is, again, that of preventing the misuse of 'soft' evaluation criteria to exclude or penalize foreign suppliers in favour of 'local' ones, thereby hindering European market integration. It is important though that KKV considers that value for money is also important, and that advocates a flexible implementation of the procurement legislation that allows

reputational forces to work at least for these forms of supply mentioned at the beginning of this section.

8 Urgent Need of Data Collection

Which are the areas in which data collection appears more urgent, and what type of data should be collected?

I am only familiar with existing data on Swedish cleaning services and elderly care, and from this limited sample it seems that Sweden is not in better shape than other European countries in terms of procurement data collection and availability, the crucial tool for performance monitoring. Whether open or restricted, legal or illegal, the outcome of procurements will remain poor in terms of value-for-taxpayer money if supplier performance is not accurately measured and monitored.

When thinking of planning a data collection effort, basic to any more serious attempt to monitor the effectiveness of Public Procurement, and not just its formal compliance to procedural rules, one has to take into account that besides prices there is quality, that ex ante contractually stipulated quality may be very different from ex post effectively delivered quality; and that there are quality aspects such as those discussed above in section 6 that can only be measured through appropriately designed and implemented Customer Satisfaction surveys.

The study of Bandiera et al. (2008) is an example of what a proper data collection effort can do in terms of Public Procurement monitoring. Based on data collected by the Italian Ministry of Finance and Statistical Agency, that study was able to identify how much inefficiency is due to corruption and how much to bureaucratic slack, and to pinpoint which type of public administrations were more inefficient and in need of action. That study did not cost anything to the public, as it was performed by independent academic researchers.

Still, that study also exemplifies the limits of what can be achieved when data collection is limited to prices and contractually specified data. Administrations manage contracts in very different ways, and high book quality for a poor contract manager will certainly mean lower effectively delivered quality than medium book quality when a good contract manager deals with the procurement. These crucial differences are not captured by that brilliant study.

Data collection is the most important limit to performance monitoring, and should be designed to include information not only on contracted prices and quality levels, but also on the degree of application/respect of contractual provisions by suppliers, on the contract manager ex-post judgment of the supplier's performance, and particularly on well crafted and administered Customer Satisfaction surveys on final user of the procured good or service.

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