

MODULE A

PUBLIC PROCUREMENT TRAINING FOR IPA BENEFICIARIES

Introduction and principles

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Introduction and principles

MODULE A

Legislative framework and basic principles

PART 1

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SECTION 1 INTRODUCTION

1.1 OBJECTIVES

The objectives of this chapter are to explore, explain and understand:

- How public procurement is regulated within the European Union
- Which provisions of the Treaty apply
- Which other general rules apply
- The application of secondary legislation (the Directives)
- How the European Court of Justice (ECJ) gets involved in the process
- How national procurement law has developed
- How various other national laws apply to the procurement process

1.2 IMPORTANT ISSUES

The most important issues in this chapter are understanding:

- The effect of the different sources of the rules
- The basic principles that apply to public procurement
- How national law must be adapted to the European rules [this presupposes accession and must be adapted to the local situation]

It is therefore critical to understand fully:

- The different levels of rules, where they come from, and how they interact to provide a comprehensive system of regulation
- The role of the European Court of Justice (ECJ) in interpreting the rules
- The role of the national law in completing the rules

1.3 LINKS

There is a particularly strong link between this chapter and the following modules or sections:

- Module C Part 4 on public procurement procedures and techniques
- Module E Parts 1-6 on conducting procurement procedure, which requires compliance with the basic principles

Compliance with the Treaty law principles and general law principles which apply to public procurement in the EU context is a requirement that flows through the whole procurement process, from the design of the technical specifications through the choice of award procedure and selection of tenderers to the award of the contract. Failure to respect these fundamental principles can jeopardise the entire procurement, and they apply independently of the European Directives or national procurement law [this last phrase again presupposes accession and must be adapted to the local situation].

1.4 **RELEVANCE**

This information is important for all persons implicated in the procurement process but will be of particular relevance to those procurement professionals who are responsible for procurement planning, the design of technical specifications and the preparation of tender documentation including qualification criteria, and for those involved in the evaluation process. Those responsible for contract administration will also need to ensure that the basic principles are respected during contract renegotiation (changing orders, price variation etc.).

1.5 **LEGAL INFORMATION HELPFUL TO HAVE TO HAND**

In addition to looking at some of the provisions of the Directives and national law, consideration of the basic principles that apply to public procurement in an EU context also implies knowledge of the EC Treaty, as amended. In particular, you will need to be aware of the following articles of the Treaty:

- **Article 12** on the prohibition against discrimination on grounds of nationality;
- **Article 28** on the free movement of goods and the prohibition of quantitative restrictions on imports and exports and measures having equivalent effect;
- **Article 43** on the freedom of establishment;
- **Article 49** on the freedom to provide services.

In Directive 2004/18/EC, you should consider in particular Recital 2 and Article 2.

In national law, please look at:

To be adapted to national law

SECTION 2 NARRATIVE

2.1 INTRODUCTION

In this narrative, we will first look at the context of public procurement in the European Union (EU) in order to understand better how the procurement Directives and national laws that form the basis of this training programme apply in practice. We are concerned here with two issues: the legal framework and the basic principles that flow from it. We will then turn to consider how these are translated into national law.

2.2 EU PUBLIC PROCUREMENT LEGISLATIVE FRAMEWORK

In the case of public procurement, it is necessary to look not only at the procurement Directives themselves but also at the context within which they were adopted. Even with the Directives in place, more general provisions contained in the Treaty of Rome will apply, as well as more general principles of law, which will guide the interpretation of the Directives. These elements are referred to collectively as the “EU *acquis*” throughout this manual.

2.2.1 The Treaty of Rome

The Treaty of Rome 1957 (and subsequent treaties amending the Treaty of Rome) – hereafter referred to as the “Treaty” – does not include any explicit provisions relating to public procurement. That does not mean, however, that it does not contain provisions that affect public procurement within the EU. On the contrary, the Treaty establishes a number of fundamental principles that underpin the EU. These principles apply equally to the field of public procurement. Of these fundamental principles, the most relevant in terms of public procurement are:

- *Prohibition against discrimination on grounds of nationality* (article 12 of the Treaty)

This principle embodies a standard of national treatment that requires persons in a situation governed by Community law to be placed on a completely equal footing with nationals of an EU member state, *i.e.* in a procurement context, an economic operator from one member state must be treated in the same way as an economic operator from the contracting authority’s member state. This is not the same as the principle of equal treatment, which does not rely on the concept of nationality.

This article applies only to Community nationals, individuals and legal persons who are resident in any of the member states of the Community. Nationals from third countries are excluded from the protection afforded by article 12 because they are “not within the scope of application of this Treaty”.

- *Free movement of goods and prohibition of quantitative restrictions on imports and exports and measures having equivalent effect* (article 28 *et seq.*)

This principle seeks to prevent all trading rules enacted by EU Member States that are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade. The objective is to prevent member states, through their contracting authorities, from buying only national products (“buy national”

campaigns). It applies to both distinctly applicable measures that are clearly intended to discriminate against foreign goods (such as local content clauses) and indistinctly applicable measures that apply equally to local and foreign goods but nevertheless discriminate indirectly against foreign goods in that their effect is to make market access more difficult for imported products than for local ones.

Under article 23(2), the provisions relating to the free movement of goods apply to both products originating in member states and products coming from third countries that are in free circulation in member states. Products coming from third countries are considered to be in free circulation in member states if the import formalities have been complied with and if any customs duties or charges having equivalent effect that are payable have been levied in that member state.

- *Freedom of establishment* (article 43 *et seq.*)

This principle is designed to guarantee the rights of Community nationals to establish themselves or an agency, branch or subsidiary in the territories of other member states. It also acts to protect the pursuit of activities of self-employed persons. Thus, an economic operator from a member state will be permitted to carry out a business in another member state through the establishment of a local entity.

- *Freedom to provide services* (article 49 *et seq.*)

This principle protects the rights of the nationals of member states who are established in the Community to provide commercial or professional services in the territories of other member states. This would include the right of temporary establishment in the territory of another member state for the purposes of providing a service in that member state. Thus, an economic operator based in one member state will be entitled to submit a tender in another member state without the need to set up a local entity or representative.

2.2.2 General principles of law

In addition to these fundamental principles in the Treaty, some general principles of law have emerged from the case law of the European Court of Justice (ECJ). As *general* principles, these will also be applied in the context of public procurement, and a number have, in fact, been applied by the ECJ in cases concerned with public procurement disputes. They are important because they will often be used by the ECJ to fill in gaps in the legislation and to provide solutions of principle to situations that are often very complex.

The most important of these general principles of law in the current context are the following.

- *Equality of treatment*

This principle requires that identical situations be treated in the same way or that different situations not be treated in the same way. It does not depend on nationality (as with the principle of non-discrimination) but is based on the idea of fairness to individuals. Thus treating two economic operators from the same country differently could be unequal treatment but, since they are of the same nationality, there would be no discrimination (on grounds of nationality). The Danish Bridge case provides a good example of the difference.

The ECJ: Danish Bridge case

In this case, there were two alleged breaches of procurement law at issue. First, a clause that required the use of local goods and labour. Second, the way in which the employer had given one of the tenderers the chance of putting forward a variation to the specifications contrary to the instructions set out in the tender documents. The first breach was clearly discriminatory and thus gave rise to unequal treatment between those tenderers who could fulfil the nationality condition and those who could not, even though they could meet the output specifications. The second breach was not discriminatory because it did not distinguish between national and non-national tenderers. It merely treated one tenderer differently from the others. This is unequal treatment but is not necessarily discriminatory. It could also (coincidentally) be discriminatory if it were applied to different nationalities.

Case C-234/89 *Commission v Denmark* [1993] ECR I-3353

- *Transparency*

This principle imposes an obligation of transparency on the contracting authority, which consists of ensuring, for the benefit of any potential tenderer, a degree of advertising that is sufficient to enable the opening up of the services market to competition and the review of the impartiality of procurement procedures.

The ECJ: Coname case

Where the Directives do not apply to the contract in question (either because it is outside the Directives or below the thresholds), the principle of transparency will apply, requiring some form of advertising of the proposed contract. That will be the case whenever the contract in question may be of interest to an undertaking located in another EU member state. This is not required, however, where the lack of advertising can be justified by “objective” or “special” circumstances, such as where there is only a very modest economic interest at stake.

Case C-231/03 *Consorzio Aziende Metano (“Coname”) v Padania Acque SpA (“Coname”)* [2005] ECR I-7287

Guidance on how the transparency objective might be achieved can be found in the Commission’s Interpretative Communication on the Community law applicable to contract awards not or not fully subject to the provisions of the public procurement Directives (24.07.2006).

- *Mutual recognition*

According to this principle, an EU member state must accept the products and services supplied by economic operators in other Community countries if the products and services meet in like manner the legitimate objectives of the recipient member state. In practice, this means that the member state in which the service is provided must accept the technical specifications, checks, diplomas, certificates and qualifications required in another member state if they are recognised as equivalent to those required by the member state in which the service is provided.

■ Proportionality

The principle of proportionality requires that any measure chosen be both necessary and appropriate in the light of the objectives sought. In choosing the measures to be taken, an EU member state must adopt those that cause the least possible disruption to the pursuit of an economic activity. As an example, exceptions to the Treaty principles discussed above (based on the protection of legitimate interests, such as public health or security) must be proportional to the objectives sought. In the case of contracting authorities, for instance, it could be said that when selecting candidates and tenderers, contracting authorities should not impose technical, professional or financial conditions that are excessive and disproportionate to the subject of the contract.

These general principles of law are enunciated, for the most part, by the ECJ. It does so in the exercise of its jurisdiction to apply and interpret Community law, where it uses these general principles of law to fill *lacunae* in Community law. These principles are unwritten rules, which are not contained in the Treaty but are inspired by those common general principles of law recognised in the national legal systems of EU member states.

Note on general principles: It is important to remember that these general principles apply independently of the Directives so that, even if the Directives do not apply, the principles may still apply. Thus contracts below the EU thresholds, for example, are not covered by the Directives but are subject to the general principles.

2.2.3 The EU Directives

General principles of law are difficult to apply in specific situations and tend to be negative in substance, *i.e.* they tend to proscribe incompatible behaviour but do not, at the same time, provide positive guidance on their application in the concrete situations to which they apply. It is not realistic to impose adherence to such broad principles without at the same time addressing the rules for the conduct of procurement, which previously differed widely in form throughout the membership of the European Economic Community.

It was necessary therefore to introduce procedural conformity to achieve non-discriminatory access to public procurement markets. To underpin the Treaty principles in the field of public procurement and to provide the necessary guidance to member states, the Community adopted a series of procurement Directives. Based on principles of non-discrimination and competitive procurement, the Directives are to be seen as a specific application of Treaty principles and complement them by setting out their application in the specific context of public procurement.

2.2.3.1 The main Directives

There have been a number of Directives. In the public sector, there have been three main Directives covering works, supplies and services, which have been amended many times. These Directives did not include contracts awarded by entities operating in the utility sectors of water, energy, transport or telecommunications, which have been covered since 1990 by a different series of Directives specifically for the utilities sector.

Since 2004, however, there has been a single directive that applies to the public sector and another that applies to the utilities sector:

- The public sector Directive is **Directive 2004/18/EC**.
- The utilities sector Directive is **Directive 2004/17/EC**.

These Directives cover only the procedural rules. There are two other Directives, which apply to complaints and review (*i.e.* to the enforcement of the Directives). These are known as the Remedies Directives.

- In the public sector, remedies are governed by **Directive 89/665/EC**.
- In the utilities sector, remedies are governed by **Directive 92/13/EC**.

The above two Remedies Directives have both been significantly amended by a new Directive: **Directive 2007/66/EC**, which was due to be implemented by the member states by 20 December 2009.

In addition, and as discussed further in module D4, there is now a new Directive, which applies a more flexible and confidential regime to the procurement of military supplies and related works and services: **Directive 2009/81**.

It should be added that the European Commission has supplemented these procedural and remedial Directives with further legislation dealing with various aspects of the procurement process. These include, in particular:

- **Directive 2001/78/EC** on the use of standard forms in the publication of public contract notices
- **Regulation 2151/2003** amending **Regulation 2195/2002** on the Common Procurement Vocabulary (CPV); updated CPV codes were adopted under **Regulation 213/2008**
- **Regulation 1564/2005** establishing standard forms for the publication of notices in the framework of public procurement procedures, pursuant to Directives 2004/17/EC and 2004/18/EC

2.2.3.2 Scope of the procedural Directives

The Directives are intended to co-ordinate national contract award procedures by introducing a minimum body of common procedural rules that reflect the basic Treaty principles rather than to achieve the harmonisation of all national rules on public procurement. The Directives do not seek to impose a new *common* regulatory regime on EU member states in the field of procurement, and member states can continue to apply their national procedures *adapted* to the Directives. The Directives thus limit their scope to those measures required for the co-ordination exercise and permit the member states to maintain or adopt substantive and procedural rules to the extent that these are not in conflict with the Directives or with Treaty provisions.

As a result, the member states remain free to regulate a number of issues, mainly practical matters. Thus member states may provide, for example, for the application of specific standard form tender and contract documents; they may require adherence to specific tender opening procedures or tender submission procedures; they may require the submission of appropriate tender or performance guarantees; and they may impose specific contractual obligations on public contracts resulting from public procurement.

Good practice note:

For economic operators seeking to tender for contracts in other member states, it will be important to keep in mind not only the provisions of the Directives themselves but also the applicable national rules and practices that remain unaffected (other than by reason of compatibility) by the Directives. These national rules and practices will often contain practical requirements that are not mentioned in the Directives.

Localisation: In XXX, for example, the [Procurement Law] applies the following requirements:

- XXX
- XXX

In essence, the common rules of the Directives consist of applying the basic principles referred to above, notably non-discrimination, equal treatment and transparency in the:

- publicity of proposed procurement contracts
- design of technical specifications
- choice of procurement procedure
- qualification and selection of candidates and tenderers
- award of contracts.

The Directives, however, apply only to proposed procurement contracts of a financial value above a given threshold. Rather than seeking to regulate with precision all public procurement contracts within the EU, the Community legislator chose to regulate in the Directives only those contracts that were most clearly capable of affecting trade between member states. Those falling within this broad definition include:

- (i) contracts that are of a sufficiently high value to attract economic operators from other member states (*i.e.* where the potential benefits of winning the contract outweigh the extra costs of providing the goods, works or services from a greater distance); and/or
- (ii) those contracts concerning objects that are amenable to cross-border trade.

This may require localisation: This does not mean that such contracts are not subject to competition. They are, in XXX, subject to the [Procurement Law] and, as indicated previously, to the fundamental principles of the Treaty and to general principles of law.

2.2.3.3 Structure of the Directives

One of the improvements brought about by the consolidation of the various Directives in 2004 was the simplification and streamlining of the Directives, which now evidence a greater degree of procedural logic, for example by starting with the general definitions, dealing with the scope of application (entity and activity coverage), and then essentially seeking to follow the sequential steps of the procurement process itself. This is also the general approach taken in this training programme.

Broadly, the structure (taken from the Public Sector Directive) is as follows:

- definitions and general principles
- rules on public contracts
- general provisions

- Scope: thresholds and provisions on specific situations, including exclusions and concessions
- Arrangements for public service contracts
- Specific rules governing specifications and contract documents
- Procedures
- Rules on advertising and transparency
- Conduct of the procedure: qualification and award
- Rules on public works concessions: award of public works concessions and contracts awarded by concessionaires
- Rules governing design contests
- Statistical obligations, executory powers and final provisions

2.2.3.4 “Legal effect” of the Directives

Member states are bound to take all appropriate measures to ensure the fulfilment of the obligations arising out of the Treaty or resulting from actions taken by the institutions of the Community. The procurement Directives, like all Directives, are by definition not directly applicable, *i.e.* they do not apply automatically. In order to produce their effects within the member states, they need to be implemented or “transposed” into national law. The member states are, therefore, required to take the measures necessary to give full effect to the provisions of the Directives in national law and to ensure that no other national provisions undermine their applicability. This normally takes the form of a transposition of the Directives into national law and the abrogation of all contrary legislative provisions.

The Directives are binding only in terms of the result to be achieved but leave to the national authorities the choice of form and methods. Thus, it is not necessary for EU member states to produce an exact copy of the Directives in their national legislation, although some member states have done precisely that, by reference to the Directives themselves. **Include localisation where relevant: In XXX, the method chosen is to...**

Failure to implement the Directives correctly or on time does not mean, however, that the Directives have no effect. Member states are not entitled to deprive the subjects of those Directives (contracting authorities and economic operators) of the rights they are intended to enjoy under the Directives. In accordance with the ECJ’s doctrine of “direct effect”, individuals may enforce in national courts the rights conferred by the Directives wherever the appropriate conditions are satisfied. This will happen, for example, if a member state fails to implement/transpose the Directive into national law by the due date (each Directive includes a date by which it must be transposed) or if it has transposed the Directive on time but done so incorrectly.

The conditions necessary to give rise to the direct effect of a particular Directive are as follows:

- the obligation imposed on member states is clear and precise;
- the obligation is unconditional;
- in the event of implementing measures, the member states or Community institutions are not given any margin of discretion.

The ECJ has stated that many of the provisions of the Directives do have direct effect but that each provision will be considered individually. The ECJ has found that the provisions relating to advertising, competition, selection and award criteria have direct effect. On the other hand, a number of the provisions of the Remedies Directives, which require additional choices and decisions to be taken by the member states, such as the choice of a review body, cannot – according to the third condition mentioned above – be considered as directly effective in their entirety. Nevertheless, some of the provisions of the Remedies Directives, such as the provisions relating to the available remedies (namely, articles 1(1) and 2(1)(b)), are directly effective.

Note on direct effect:

It is important to remember that economic operators may be able to rely on the provisions of the procurement Directives even if they have not been transposed into national law, provided the conditions are met.

2.3 NATIONAL PUBLIC PROCUREMENT LEGISLATIVE FRAMEWORK

This requires extensive localisation and should cover the following:

2.3.1 Primary public procurement law

- History
- Structure
- Scope of regulation

2.3.2 Secondary public procurement legislation

2.3.3 Other relevant legislation

- Administrative law
- Contract law
- Criminal law
- Budget law
- Other special laws

2.4 BASIC PRINCIPLES OF PUBLIC PROCUREMENT

Discussion of the European and national legislative frameworks discloses the basic principles that apply to public procurement.

From its origins, one of the main objectives of the EU has been to create a common market that eliminates barriers to trade in goods and services between EU member states. Creating a common procurement market means removing any barriers to trade arising from the procurement context.

The ECJ

“The purpose of coordinating at Community level the procedures for the award of public service contracts is to eliminate barriers to the freedom to provide services and therefore to protect the interests of economic operators established in a Member State who wish to offer goods or services to contracting authorities in another Member State.”

Case C-360/96 *Gemeente Arnhem v BFI Holding BV* [1998] ECR I-6821

Barriers to trade can be erected by means of legislation or by the actions of contracting authorities or economic operators. Legislation can create barriers by imposing “buy national” requirements. Contracting authorities can impose barriers by making discriminatory award decisions. Economic operators can also create barriers by colluding together to rig tender prices. All of these barriers have the effect of distorting competition in the common procurement market, and one of the primary purposes of public procurement legislation is to eliminate existing barriers and prevent the erection of new barriers. It does so by applying the basic principles flowing through the legislation.

While they are all inter-linked, these principles can, for current purposes, be reduced to a series of core principles:

■ *Competition*

From an economic perspective, “competition” operates as a discovery procedure by allowing different economic operators to communicate the prices at which goods and services are available on the market. Those prices act as guideposts and reflect the demand and supply conditions at any given moment. They also reflect the differences in quality and in terms and conditions of sale of the different (non-homogenous) products available.

This is why the advertising provisions discussed in module E2 are so important, as they guarantee the widest possible competition, enabling economic operators from all over the Community to communicate their prices to a given contracting entity, thus ensuring the greatest possible choice. This is also one reason why transparency is a core principle, since it ensures the widest possible publicity for procurement contracts.

Keeping competition fair (or maintaining a “level playing field”) is a key concern for achieving efficient and economic procurement results. Procurement legislation seeks to prevent any distortions or restrictions of competition within the Community, and any attempt to prevent economic operators from being able to tender will be prohibited. Such attempts can take many forms and can affect the products or services or the economic operator itself. As a result, the legislation prohibits:

- barriers to the free movement of goods, *e.g.* import restrictions, customs duties, local content rules, “buy national” policies, national technical specifications or standards that prevent the sale of non-domestic products;
- barriers to the freedom to provide services, *e.g.* attempts to restrict foreign economic operators from tendering through the use of local registration requirements, compliance with national professional standards or possession of local qualifications.

Protecting competition is also a question of maintaining equality of treatment, avoiding discrimination, applying mutual recognition principles (of equivalent products and qualifications), and ensuring that any exceptions are proportional.

■ *Equal treatment and non-discrimination*

The concepts of equal treatment and non-discrimination are not the same. In general terms, all procurement legislation will seek to maintain equality between economic operators. In the European context, however, that equality will also be based on “nationality”.

Equal treatment is a concept that generally requires identical situations to be treated in the same way or different situations not to be treated in the same way, and it requires the identical treatment of identical people. In a sense, it implies that contracting authorities will not take into account the different abilities or difficulties faced by individual economic operators but will judge them purely on the results of their efforts, *i.e.* on the basis of the tenders they submit. It provides for an objective assessment of tender prices and tender qualities and ignores any considerations that are not relevant to the discovery of the economically efficient tender.

In the European context, the concept of equal treatment requires yet another definition since, in this context, the concept of equality is, in addition, based on nationality or on the origin of goods, such that all economic operators of Community nationality and all bids including goods of Community origin must be treated equally (this is the principle of non-discrimination). This is more than simply an extension of the concept of equal treatment. It implies that any condition of eligibility or origin (based on nationality or local provenance) will automatically give rise to unequal treatment, since those conditions will, by definition, discriminate against a certain group of (foreign) economic operators or favour another. However, while discrimination in a given context will produce unequal treatment, unequal treatment does not always give rise to discrimination. This point is conveniently illustrated by the *Danish Bridge (Storebaelt)* case (Case C-234/89 *Commission v Denmark* [1993] ECR I-3353) explained in 2.2.2 above.

■ *Transparency*

“Transparency” has only recently emerged as a principle in its own right, although it is probably better to think of it as a tool to be used to achieve other objectives. For example, publication and accessibility of the legislation provides clarity and certainty for all stakeholders and enables contracting authorities and economic operators to be aware of the rules of the game. The Directives apply requirements of advertising that guarantee transparency in the discovery process, *i.e.* guaranteeing the widest possible competition. Publicising in advance the technical specifications and the selection and award criteria permits stakeholders to check that these are fair and non-discriminatory. Recording and reporting requirements ensure that the actions of the contracting authorities may be verified where appropriate. The latter objectives are also a fundamental aspect of “accountability”, *i.e.* holding procurement officers accountable for their decisions and actions. “Accountability” is also often an explicit objective of national procurement systems, and the transparency provisions reinforce this accountability.

The importance of the principle of transparency in the EU context, however, is that it applies independently of the legislation. So, if a particular procurement contracts falls below the threshold values of the EU legislation (or national legislation) or if a procurement is excluded from the scope of the Directives, e.g. public services concessions or the procurement of certain non-priority services, then it is possible that the principle of transparency will continue to apply so as to impose advertising requirements.

The ECJ has consistently stated that even if certain contracts are excluded from the scope of Directives, the contracting entities concluding them are nonetheless bound to comply with the fundamental rules of the Treaty in general and with the principle of non-discrimination on the grounds of nationality in particular. This implies an obligation of transparency in order to enable the contracting authority to satisfy itself that the principle has been complied with.

That obligation of transparency consists in ensuring, for the benefit of any potential tenderer, a degree of advertising sufficient to enable the opening up of the services market to competition and the review of the impartiality of procurement procedures.

The “degree of advertising” required will often depend on the member state in question, especially where there are provisions regulating low-value contracts. Localise as appropriate: In XXX, the [Procurement Law] applies... These procedures are discussed further in modules C4 and E2.

The principle of transparency will apply whenever the contract in question may be of interest to an undertaking located in another member state. That would not be the position, however, where the lack of advertising can be justified by “objective” or “special” circumstances. Such special circumstances will exist, at least where there is only a very modest economic interest at stake.

Some of the above principles are articulated differently or combined in national legislation. You might, for example, find principles stated in legislation, such as:

- *Economy and efficiency*

This is a principle that is often used to describe the technical efficiency of the procedure itself, i.e. whether the planning has been appropriate and carried out on time; whether the various responsibilities have been engaged; whether sufficient time has been given to economic operators to prepare suitable tenders; whether the procurement is made in a timely manner. At a more “economic” level, the principle can also be used to identify whether the correct or best contracting strategies (see module A4) have been used to minimise waste and benefit from economies of scale. At a policy level, the principle may be used to analyse the allocative efficiency of transactions and of the system as a whole to determine whether this can be optimised further.

- *Value-for-money*

Value-for-money is a loosely defined term used predominantly in Anglo-Saxon countries. To some extent, it overlaps with the concepts of economy and efficiency so that the procurement procedure is carried out with the least waste (in terms of cost and time) and as much benefit as possible. It comes into its own, however, when dealing with the setting of requirements and evaluation.

The basic premise is that the government should only buy what is actually needed: leather-covered chairs should not be bought where plastic chairs will do (e.g. in a waiting room). In other cases, leather-covered chairs may be preferred (e.g. in the boardroom). While it is for the contracting authority to decide what to buy, the point is that the specifications must match the real needs of the contracting authority.

The principle of value-for-money also recognises that goods and services are not homogenous, *i.e.* that they differ in quality, durability, longevity, availability and other terms of sale. The point of seeking value-for-money is that contracting authorities should purchase the optimum combination of features that satisfy their needs. Therefore the different qualities, intrinsic costs, longevity, durability, etc. of the various products on offer will be measured against their cost. It may be preferable to pay more for a product that has low maintenance costs than a cheaper product with a higher maintenance cost.

Example: Purchase of printers

There are three laser jet printers on offer, all of which provide the same technical output in terms of pages per minute:

Printer A: Cost of EUR 500, cost of toner EUR 175, life of toner 8 000 pages

Printer B: Cost of EUR 600, cost of toner EUR 190, life of toner 10 000 pages

Printer C: Cost of EUR 800, cost of toner EUR 50, life of toner 8 000 pages

Printer A is the lowest price, but does it offer value-for-money?

That depends on use.

For an office sending out occasional letters and preparing occasional reports with an output in terms of pages that is relatively low, the difference in toner prices and longevity is mostly irrelevant. On the assumption that the office produces about 10 000 pages every six months, the real cost of the printers over a 24-month period is:

Printer A: EUR 500 + EUR 875 (5 x EUR 175) = EUR 1 375

Printer B: EUR 600 + EUR 760 (4 x EUR 90) = EUR 1 360

Printer C: EUR 750 + EUR 700 (5 x EUR 140) = EUR 1 450

Printer B probably offers the best value-for-money.

However, assume that the office in question is responsible for generating weekly reports of activities and has an output of closer to 30 000 pages every six months.

The real cost of the same printers for that 24-month period would be:

A: EUR 500 + EUR 2 625 (15 x EUR 175) = EUR 3 125

B: EUR 600 + EUR 2 280 (12 x EUR 90) = EUR 2 880

C: EUR 750 + EUR 2 100 (15 x EUR 140) = EUR 2 850

For this office, Printer C, with the highest initial cost, is beginning to look like the best value-for-money.

If these printers are in use for many years and if the offices purchase several printers, then the savings to be made from buying the more expensive printers become significant.

In this sense, “value-for-money” broadly equates, in EU terms, to the award criterion of the “*most economically advantageous tender*”, which allows factors other than only price to be taken into account during the evaluation. See further in module E5.

- *Probity or integrity*

Procurement legislation will also serve to reduce the opportunities for corrupt practices. It does this by imposing accountability and transparency requirements so that the activities of procurement officers can be checked and verified, thereby reducing the possibility that such officers will act in their own self-interest. The procurement officers must clearly set out in a public manner the requirements that they intend to procure as well as the selection and award criteria to be applied. Their decisions will be recorded and can later be verified either by the government (internal or external audit) or by aggrieved economic operators.

Some national laws make probity and integrity an explicit objective and they often include in the procurement legislation additional clauses of a practical nature seeking to enforce probity (e.g. conflicts of interest provisions or the compulsory application of “integrity pacts”), together with consequential provisions addressing the actions to be taken where corrupt practices have been found to exist. As discussed in module E3, previous convictions for corrupt practices can also lead to automatic disqualification from a procurement procedure.

Localisation required: In XXX, for example, the [Procurement Law] is explicitly based on the following principles:

MODULE
A

Introduction
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SECTION 3 EXERCISES

EXERCISE 1

You work for a local hospital and your boss, the new head of procurement, has some questions. She knows the applicable legislative provisions and understands the procurement process, but she is trying to understand how the basic principles affect the procurement function within the hospital.

1. Does the fact that low-value purchases fall below the thresholds of the law mean that she can carry out the purchases however she likes?
2. She asks whether the principle of transparency means simply that she needs to advertise according to the law.
3. She wonders whether there is anything in the Treaty principles that would oblige her to employ staff from overseas because she is not sure that they are as well qualified as [localise] staff.
4. There have been questions about the quality of sutures coming from certain European countries – does she have to buy the cheapest one regardless of quality?
5. There has been much talk of the new generation of keyhole surgery cameras. They are more expensive than existing models and she asks you to help provide a business case for purchasing the new cameras. What issues would you raise?
6. A local TV celebrity chef has been complaining that the hospital sources foodstuffs from abroad and the patients have been complaining of being forced to eat foreign food. Can she make it a condition that food products should always be locally sourced?
7. Local environmental groups have been complaining about the plastic waste of the hospital which comes mainly from drink packaging. The plastic bottles that are the basis of the complaint are produced by foreign companies, and she has discovered that most national companies supply glass bottles that are recyclable. She thinks she can avoid the problem by making it a requirement that only glass bottles may be supplied for environmental reasons. Is she right?

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Exercises

EXERCISE 2 POTENTIAL BREACH OF BASIC PRINCIPLES

Match the potential breach on the right to the principle(s) on the left

Clue: there could be more than one connection per principle

PRINCIPLE

FREE MOVEMENT

EQUAL TREATMENT

NON-DISCRIMINATION

TRANSPARENCY

MUTUAL RECOGNITION

PROPORTIONALITY

POTENTIAL BREACH

Allowing only tenderers registered in the member state of the contracting authority

Allowing only tenderers with a professional qualification from the member state of the contracting authority

Excluding all products not conforming to national environmental standards

Allowing only products conforming to national technical standards

Requiring the use of local goods and labour

Changing the specifications to match a preferred tender

Remaining silent on the selection criteria to be applied

Imposing a "buy national" policy

EXERCISE 3
GROUP DISCUSSION ON TRANSPARENCY

Split into groups of no more than 6 each for a debate on the application of the principle of transparency to below-threshold procurement.

Half of the groups will take the position that the imposition of such a principle is positive.

The other half will take the position that the imposition of such a principle is negative.

Issues to be addressed include (but are not limited to):

- whether transparency is required at all levels for reasons of accountability and probity
- whether economy and efficiency require a cut-off point below which the transparency principle does not apply
- the place of a cost/benefit analysis in the debate (cost of transparency/consequential benefit to contracting authority)
- whether the principle of proportionality has any role to play
- how such a principle is to be implemented and enforced

Each group is to present their arguments and conclusions in turn. A vote is to be taken at the end.

SECTION 4 THE LAW

EXTRACTS FROM DIRECTIVE 2004/18/EC

Recital 2: *Principles deriving therefrom, such as the principle of equal treatment, the principle of non-discrimination, the principle of mutual recognition, the principle of proportionality and the principle of transparency. However, for public contracts above a certain value, it is advisable to draw up provisions of Community coordination of national procedures for the award of such contracts which are based on these principles so as to ensure the effects of them and to guarantee the opening-up of public procurement to competition. These coordinating provisions should therefore be interpreted in accordance with both the aforementioned rules and principles and other rules of the Treaty.*

Article 2: Principles of awarding contracts

Contracting authorities shall treat economic operators equally and non-discriminatory and shall act in a transparent way.

Localisation: Extracts from national law:

EXTRACTS FROM THE TREATY OF ROME, AS AMENDED:

Article 12 on the prohibition against discrimination on grounds of nationality:

Within the scope of application of this Treaty, and without prejudice to any special provisions contained therein, any discrimination on grounds of nationality shall be prohibited.

The Council, acting in accordance with the procedure referred to in Article 251, may adopt rules designed to prohibit such discrimination.

Article 28 on the free movement of goods and the prohibition of quantitative restrictions on imports and exports and measures having equivalent effect

Quantitative restrictions on imports and all measures having equivalent effect shall be prohibited between Member States.

Article 30 on permitted exceptions to the free movement of goods and the prohibition of quantitative restrictions on imports and exports and measures having equivalent effect:

The provisions of Articles 28 and 29 shall not preclude prohibitions or restrictions on imports, exports or goods in transit justified on grounds of public morality, public policy or public security; the protection of health and life of humans, animals or plants; the protection of national treasures possessing artistic, historic or archaeological value; or the protection of industrial and commercial property. Such prohibitions or restrictions shall not, however, constitute a means of arbitrary discrimination or a disguised restriction on trade between Member States.

Article 43 on the freedom of establishment:

Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.

Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 48, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the chapter relating to capital.

Article 49 on the freedom to provide services:

Within the framework of the provisions set out below, restrictions on freedom to provide services within the Community shall be prohibited in respect of nationals of Member States who are established in a State of the Community other than that of the person for whom the services are intended.

Article 50 on the definition of services:

Services shall be considered to be "services" within the meaning of this Treaty where they are normally provided for remuneration, in so far as they are not governed by the provisions relating to freedom of movement for goods, capital and persons.

"Services" shall in particular include:

- (a) activities of an industrial character;*
- (b) activities of a commercial character;*
- (c) activities of craftsmen;*
- (d) activities of the professions.*

Without prejudice to the provisions of the chapter relating to the right of establishment, the person providing a service may, in order to do so, temporarily pursue his activity in the State where the service is provided, under the same conditions as are imposed by that State on its own nationals.

SECTION 5 CHAPTER SUMMARY

SELF-TEST QUESTIONS

1. Does the Treaty of Rome, as amended, itself regulate procurement in the EU?
2. Describe the Treaty principles that apply to procurement.
3. What is the difference between the freedom of establishment and the freedom to provide services? How does each freedom assist tenderers from different member states?
4. Name the core general principles of law that apply to procurement.
5. Where do these general principles of law come from?
6. What is the difference between the principle of equality of treatment and non-discrimination?
7. Describe the principle of transparency.
8. When does the principle of transparency apply?
9. If the European directives have not been transposed into national law, do the Treaty principles or general principles of law matter? Why?
10. Identify the main procedural directives.
11. Are there any other directives that are important?
12. Do the directives provide a complete procurement code for the member states?
13. What, if anything, remains within the jurisdiction of the member states?
14. Do the directives apply to all contracts? Which contracts are not covered?
15. What distinguishes the coverage of the directives from the coverage of the national rules?
16. Set out the essential rules of the directives.
17. What happens if the directives are not transposed into national law by the deadline?
18. What happens if the member states transpose a directive incorrectly?
19. What is the main purpose of the European directives?
20. Identify four barriers to trade that could be erected by different players in the procurement market.
21. What is competition, and why is it important?
22. Why is advertising important to competition?
23. Explain the concept of non-homogenous products and services.
24. What effect do these have on competition?
25. Use the Danish Bridge case to explain the concept of equal treatment.
26. Explain the concept of "value-for-money".
27. In your opinion, should price be the only award criterion? Why?



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Chapter summary

FURTHER READING

The various texts that make up the EU legislative framework, along with a range of other useful documents and links, can be found on the DG Market website at:

http://ec.europa.eu/internal_market/publicprocurement/legislation_en.htm

This includes the Commission interpretative communication on the Community law applicable to contract awards not or not fully subject to the provisions of the Public Procurement Directives (24.07.2006).

The XXX legal framework can be found at: [XXXXXXXXXXXXXXXXXX](#) (localisation required)

The EU Treaty texts can be found at: <http://www.eurotreaties.com/eurotexts.html>

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SECTION 1 INTRODUCTION

1.1 OBJECTIVES

The objectives of this chapter are to explore, explain and understand:

- The institutions that are involved at European level
- The institutions that are involved at national level
- The role of the contracting authorities
- The way in which these actors relate to each other

1.2 IMPORTANT ISSUES

The most important issues in this chapter are understanding:

- The legislative and regulatory functions of the various bodies
- The duties and obligations of the contracting authorities
- The importance of implementation and enforcement
- It is therefore critical to understand fully:
 - The division of labour between these institutions
 - The key functions and sources of authority of these institutions
 - The limitations of each of these institutions *vis-à-vis* the others

1.3 LINKS

There is a particularly strong link between this chapter and the following modules or sections:

- Module A1 on the basic principles of public procurement and the legislative framework
- Module B on the duties of the contracting authorities
- Module F on review and remedies
- Module G on contract management

1.4 RELEVANCE

This information is important for all persons implicated in the procurement process because it provides a background to the institutions involved. It is of particular relevance to procurement officers who will need to communicate and liaise with the national institutions for information, guidance and assistance through the procurement process, and those that are implicated in review procedures.



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1.5 LEGAL INFORMATION HELPFUL TO HAVE TO HAND

[Localisation required: It will be useful to refer to [xxxxx law/regulation] which contains a description of the duties and functions of the relevant national bodies, namely XXXX and XXXX]

In addition, it may be useful to refer to the following Papers prepared by OECD/SIGMA, which consider the institutional framework of a number of EU Member States in respect of public procurement.

SIGMA Paper No. 40:

[Central Public Procurement Structures and Capacity in Member States of the European Union](#)

SIGMA Paper No. 41:

[Public Procurement Review and Remedies Systems in the European Union](#)

SECTION 2 NARRATIVE

2.1 INTRODUCTION

The institutional framework operates at two levels: the European level and the national level.

Contracting authorities, which may also be considered as “institutions”, are bound by the provisions of the Directives and the national provisions that transpose them. They are answerable both to the European Commission as emanations of an EU Member State and to individual economic operators, which may rely on the Remedies Directive to challenge infringements by them in the national bodies.

2.2 EUROPEAN INSTITUTIONAL FRAMEWORK

A number of different organisations are implicated in procurement at the European level. These organisations are the following:

2.2.1 Community Legislator

Although the Treaty (Treaty of Rome 1957 and treaties amending the Treaty of Rome) uses different terminology, the Community Legislator is, in effect, the Council of the European Communities, acting either alone or in co-operation with the European Parliament. All recent procurement Directives were adopted by these two institutions acting together, using the “co-decision” procedure.

The Council has been assigned the role of ensuring co-ordination of the general economic policies of the member states, and conferred the power both to take decisions and to in turn confer on the Commission, in the acts that it adopts, powers to implement the rules laid down by the Council.

Crucially, however, the Council does not have the right of initiative. Thus, it does not have the power to enact legislation that has not been proposed by the Commission.

2.2.2 Role of EU member states

For the purposes of the EU, the member states are bound to take all appropriate measures to ensure the fulfilment of the obligations arising out of the Treaty or resulting from actions taken by the institutions of the Community. They are required to facilitate the achievement of the Community’s tasks and must abstain from any measure that could jeopardise attainment of the objectives of the Treaty.

In terms of the Directives, the member states are (therefore) required to take the measures necessary to give full effect to their provisions in national law and to ensure that no other national provisions undermine their applicability. This normally takes the form of a transposition of the Directives into national law and the abrogation of all contrary legislative provisions.

It is important to note that although the Directives are directly effective (where specific conditions are met – see module A1) in that they can convey rights even if not implemented, they are not directly applicable, *i.e.* they need to be transposed into national law.

Moreover, they are binding only in terms of the result to be achieved, but leave to the national authorities the choice of form and methods. Thus it is not necessary for the member states to produce an exact copy of the Directives in their national legislation. This is also discussed in module A1.

Provided they achieve the same results, national authorities can reproduce the provisions of the Directives in identical fashion by amending existing legislation or by creating new legislation or codes, etc.

Localisation required: In XXX, the relevant provisions of the Directives are, for example, transposed by the [XXX] (where that is the process chosen).

2.2.3 **Role of the European Commission**

In addition to acting as the proposer of legislation, the European Commission has also been given by the Treaty the role of its guardian. It is given the explicit task of ensuring that the provisions of the Treaty and the measures taken by the institutions pursuant to it are applied.

Thus, in addition to having acted as the primary policy maker in the field of procurement, the Commission is also responsible for the application and general enforcement of the Directives. In the case of procurement, the responsible directorate-general is DG-Markt.

Implementation measures taken by DG-Markt include the adoption of secondary legislation to provide, for example, for the use of standard forms, the Common Procurement Vocabulary (CPV), interpretative guidelines and communications, and general guidelines.

While enforcement in national courts/review bodies against contracting entities in breach of their obligations is at the suit of interested economic operators, infringements by those public authorities, as emanations of the member state, will simultaneously amount to a failure of the member state to fulfil its obligations under the Treaty.

Such a failure may be challenged directly by the Commission before the European Court of Justice (ECJ) through infringement proceedings brought under article 226 of the Treaty. This process is described in detail in module F1.

2.2.4 **Role of the European Court of Justice**

There are two Community-level courts, each with its own jurisdiction: the Court of First Instance (CFI) and the European Court of Justice (ECJ). In most cases related to procurement, it is the ECJ that is of most interest.

The ECJ ensures observance of the law in the interpretation and application of the Treaty and its implementing rules. To this end, a number of powers have been expressly conferred on the ECJ. These powers are mainly intended to enable the ECJ to judge the acts and omissions of the institutions and the member states in accordance with Community law and to ensure uniformity in the interpretation of Community law and in the application of this law by the national courts.

There are three areas of the ECJ's work that are important in the case of procurement.

- *Dispute resolution*

Under article 226 of the Treaty, the ECJ has jurisdiction to hear disputes between the Commission, acting as guardian of the Treaty, and member states in respect of a member state's failure to fulfil its obligations under the Treaty. These are often referred to as the Commission's infringement proceedings.

Thus, the Commission will bring infringement cases against member states before the ECJ. Such actions may result from a failure to transpose the Directives correctly into national law or from a failure of a contracting authority to properly apply the Directives, the national provisions transposing them, or other enforceable Community law, such as the Treaty itself.

- *Preliminary rulings*

A critical power conferred on the ECJ is the power, granted by article 234 of the Treaty, to pronounce, by means of a preliminary ruling, on the *interpretation* of the Treaty and on the *validity* and *interpretation* of acts of institutions of the Community if a question on this subject is raised before a national court or tribunal.

Thus in disputes between member states and private persons, or between private persons themselves, questions relating to the interpretation, application and validity of Community law that arise in the context of national proceedings may be referred to the ECJ. Where such questions arise in the context of a procurement dispute that has been brought in a national court/review body under the Remedies Directive, for example, the national courts may refer them for interpretation to the ECJ. Under this procedure, the national court/review body will establish the facts of the case and formulate questions of interpretation for the ECJ, the answers to which are necessary for the resolution of the case.

- *General principles of law*

In the exercise of its jurisdiction, the ECJ has cause to apply and interpret Community law and, in so doing, has often sought to fill lacunae in Community law by reference to general principles of law. These are unwritten rules, not contained in the Treaty but inspired by those common general principles of law recognised in the national legal systems of EU member states.

Where decisions by the Commission impact on economic operators, they may be brought before the Court of First Instance (CFI).

Section 4 below contains a practical note explaining how to find and use ECJ cases.

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Narrative

2.3 NATIONAL INSTITUTIONAL FRAMEWORK

Implementation and enforcement of procurement rules take place mostly at national level. In the case of XXX, the following institutions have been set up to carry out these tasks.

Localisation required:

2.3.1 Public Procurement Office/Agency

2.3.2 Procurement Review Body

2.3.3 Organisation at level of contracting authorities and contracting entities – procurement departments/units; (certified) procurement officers.

Provide link to module B.

2.3.4 Centralised procurement - central purchasing agency

Provide link to module A4

SECTION 3
EXERCISESEXERCISE 1
EUROPEAN COMMISSION AS GUARDIAN OF THE TREATY

Compare and contrast article 226 of the Treaty and article 8 of Directive 89/665, as amended by Directive 2007/66.

Consider the following questions:

1. Are these both the same procedure?
2. If not, what are the differences?
3. Is one better than the other (faster, more efficient, more effective)?
4. What conditions apply to each?
5. What benefits does the Commission accrue in using one or the other?

Relevant/useful texts for Exercise 1:1. Article 226 of the Treaty

If the Commission considers that a member state has failed to fulfil an obligation under this Treaty, it shall deliver a reasoned opinion on the matter after giving the State concerned the opportunity to submit its observations.

If the State concerned does not comply with the opinion within the period laid down by the Commission, the latter may bring the matter before the ECJ.

2. Directive 89/665, as amended by Directive 2007/66:**Article 8: Corrective mechanism**

1. The Commission may invoke the procedure provided for in paragraphs 2 to 5 when, prior to a contract being concluded, it considers that a serious infringement of Community law in the field of procurement has been committed during a contract award procedure falling within the scope of Directive 2004/17/EC, or in relation to Article 27(a) of that Directive in the case of contracting entities to which that provision applies.
2. The Commission shall notify the member state concerned of the reasons which have led it to conclude that a serious infringement has been committed and request its correction by appropriate means.
3. Within 21 calendar days of receipt of the notification referred to in paragraph 2, the member state concerned shall communicate to the Commission:
 - (a) its confirmation that the infringement has been corrected;
 - (b) a reasoned submission as to why no correction has been made; or
 - (c) a notice to the effect that the contract award procedure has been suspended either by the contracting entity on its own initiative or on the basis of the powers specified in Article 2(1)(a).
4. A reasoned submission communicated pursuant to paragraph 3(b) may rely among other matters on the fact that the alleged infringement is already the subject of judicial review proceedings or of a review as referred to in Article 2(9). In such a case, the member state shall inform the Commission of the result of those proceedings as soon as it becomes known.

5. Where notice has been given that a contract award procedure has been suspended in accordance with paragraph 3(c), the member state concerned shall notify the Commission when the suspension is lifted or another contract procedure relating in whole or in part to the same subject matter is begun. That new notification shall confirm that the alleged infringement has been corrected or include a reasoned submission as to why no correction has been made.

3. Extract from P. Trepte, *Public Procurement in the EU* (OUP, 2006)

(2) Procedure under Article 226 (B)

9.123 Once the complaint has been delivered, the case is out of the complainant's hands. The Commission services may request further information from the complainant but the conduct of the case from this stage on is entirely the responsibility of the Commission. The complainant may not force the Commission to proceed and withdrawing the complaint, at this stage, will not necessarily halt the procedure. This is, of course, a tactical weapon in the hands of potential complainants. Where there has been a complaint, the Commission services will investigate the complaint to establish the existence or not of any breaches of Community law. The Commission may nevertheless follow the same procedure *ex officio* where it has discovered a potential breach by other means.

9.124 If the Commission decides that, in its view, there are no breaches there is little the complainant can do and an individual may not force the Commission to act.¹ If he is informed of this conclusion, he may attempt more persuasion but, if the complaint was originally carefully drafted and properly documented, there is not much chance of success. Equally, if the complaint did not contain sufficient information or evidence the impact of the complaint may have been lost and the tactical set-back will be difficult to overcome. If the Commission decides that there are breaches of Community law, it will take formal steps to correct the situation. It will normally use the procedure provided for in Article 226 of the Treaty.²

(a) Contacting the member state authorities (C)

9.125 The Commission will contact the member state authorities concerned, raising the alleged infringements and requesting the member state to submit its observations. It will do this by way of formal notice (*lettre de mise en demeure*). There is no time limit for this part of the procedure and much will depend on the importance given to the infringement by the Commission services. In practice, this 'administrative stage' is often beset by a good deal of prevarication on the part of the member states. If the Commission feels that it is a priority matter, this procedure will have a speedy journey through the bureaucracy's machinery. If not, the complainant will have to be patient. In *Sankt Pölten*³, for example, in view of the perceived urgency of the case, the Commission provided only a week for Austria to reply.

9.126 The member state will usually reply to the Commission's objections. It may be that the member state concerned will amend its national provisions bringing to an end the alleged infringement. Alternatively, it may defend its position and claim that there is no infringement either in fact or in law.

¹ Case 48/65 *Lütticke v EC Commission* [1966] ECR 19.

² There is also a separate procedure under Art 228 where a member state relies on the provisions of Art 296 or 297 in respect of military equipment or war and other exemptions.

³ Case C-328/96 *Sankt Pölten*.

If the complainant is fortunate enough to be informed of the different positions (and there is no right to this information), he may wish to make further comments. The likely situation, however, is that the complainant must hope to have supplied the Commission with sufficient facts and evidence to rebut the defence.

(b) *Reasoned opinion from the Commission (C)*

9.127 If the Commission is not satisfied with the member state's response, it will issue a 'reasoned opinion'. This will include a full statement of the facts and a formal statement of the infringements of Community law alleged to have taken place. The reasoned opinion will require the infringements to be brought to an end but will not normally suggest the measures to be taken. There is no set time limit between the previous stage and the issue of reasoned opinion but there will be a time limit within which the member state is required to comply. This would usually be set at two months but can be shorter where urgency requires. Again, in the *Sankt Pölten*⁴ case, Austria was given a mere 14 days to respond to the reasoned opinion but, as the ECJ made clear in that case, such short time limits would need to be justified.

(c) *Court of Justice (C)*

9.128 If the member state does not comply within the time limit set, the matter will be brought before the ECJ in Luxembourg. Due to the pressures on the ECJ, it is unlikely that a judgment would be forthcoming before about 18 to 24 months. There is an expedited procedure before the ECJ⁵, but the ECJ has apparently indicated⁶, in the context of the expedited procedure for preliminary rulings, that that possible delay to an individual procurement does not satisfy the requisite condition of urgency to bring the expedited procedure into play.⁷ If the final result is a judgment against the member state, the latter will be obliged to bring the infringement(s) to an end. The complainant does not have any standing in the ECJ procedure, may not be represented and may make no comments even as an observer. Contributions from the complainant will be limited to the contents of the complaint.

9.129 As will be surmised from the above, the value of the complaint lies largely in the initial stages. First, the threat of a complaint, where that can be made, may 'encourage' the offending authority to comply with Community law. Secondly, the initial reaction of the Commission in the form of a letter to the member state concerned may well achieve the same effect. Thirdly, the threat or the issue of a 'reasoned opinion' may also lead to compliance.⁸ If the case goes to Luxembourg, the immediate value is lost because such an action could take about a minimum of two and a half years from the date the complaint is sent. If the ECJ agrees that there has been an infringement, that infringement must be brought to an end and the complaint will have been successful in legal terms. Failure to comply with the judgment can lead to the imposition of fines.⁹ The commercial and financial success of the complaint for the complainant is a more difficult calculation to make.

⁴ *ibid.*

⁵ Introduced by the Amendments to the Rules of Procedure of the Court of Justice of the European Communities (OJ 2000 L322).

⁶ See *S. Arrowsmith* (above) at 1451.

⁷ The expedited procedure has, however, been used by the CFI against procurement conducted by the Community institutions: case T-211/02 *Tideland Signal v Commission* [2002] ECR II-3781.

⁸ The *Danish Bridge* case settled at the end of the summary hearing.

⁹ Art 228(2); see also case C-304/02 *Commission of the European v French Republic*.

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EXERCISE 2 CASE SEARCH

Using the Internet, find the case known as "*Beentjes*" and provide:

- its full case reference, including reporting details
- the name of the Advocate General
- details of any cases referred to in that case
- a short summary of the findings of the ECJ, and
- an explanation of the role played by the ECJ in that decision (*i.e.* which of the roles discussed in section 2.2.4 was important)



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Exercises

EXERCISE 3 NATIONAL EXAMPLE

(to be localised)

SECTION 4 FINDING AND USING THE CASES OF THE EUROPEAN COURT OF JUSTICE

The jurisdiction of the European Court of Justice (“the ECJ”) is described in section 2.2.4. As stated in that section, the decisions of the Court of First Instance (CFI) are of less concern in the case of procurement, although might occur in the event of a challenge against a decision of the Commission affecting procurement. One such case was the unsuccessful challenge of the Commission’s decision to reject the supplier’s tender under a PHARE programme procurement:

Case T-185/94 *Geotronics v Commission* (“*Geotronics*”) [1995] ECR II-2795.

There is no appeal from the decisions of the ECJ. An appeal lies to the ECJ from the decisions of the CFI. For example, the judgment of the CFI in *Geotronics* was appealed to the ECJ:

Case C-395/95 *Geotronics v Commission* [1997] ECR I-2271.

4.1 CASE REFERENCES

The case referred to above serves to demonstrate the method of referring to cases.

The first item is the *case number*. The letter “T” indicates a case brought before the CFI. The letter “C” indicates a case brought before the ECJ. This is followed by a roll number (*i.e.* the first case introduced in any one year would be 1, the second 2, etc. . .) and the year in which the case is filed. Before the establishment of the CFI in 1989, the letters “C” and “T” were not used in case references, since there was only one court.

This is followed by the *case name*. These are the names of the parties. Where the case is made on a preliminary reference from a national court, the case will retain the name of the original parties. In a direct action, the first name will be the name of the entity bringing the case, the second the name of the defendant. Where the case is the result of an action brought by the European Commission under article 226 of the Treaty, the first name will be that of the Commission and the second the name of the member state against which the case has been brought. In the case of an appeal, the first name will be that of the entity bringing the appeal.

Especially in the case of Commission actions against member states, this often raises some confusion because there will be a large number of cases brought against any given member state relating to numerous provisions of the Treaty and secondary legislation. Often, therefore, commentators will give significant cases an abbreviated name (sometimes preceded by the Latin *sub nom.*), either relating to one of the parties or, in the case of procurement, referring to the object of the procurement. Thus, an early case brought by the Commission against Ireland (case 45/87 *Commission v Ireland* [1987] ECR 1369) is generally referred to as “Dundalk” after the name of the contracting authority, which was the Dundalk Urban District Council. Another case involving the construction of a bridge over the Storebaelt in Sweden (case C-243/89 *Commission v Denmark* [1993] ECR I-3353) is often referred to as either the “Danish Bridge” or the “Storebaelt” case.

After this, and once the case has been decided and reported, comes the reference of the *case report*. While there are some commercial providers of case reports that will include cases of a European dimension, the official reference is the European Court Reports (“ECR”), which provides the only authentic version of the judgments.

The method for citing report references is to set out first the year of the volume in which the judgment is reported, followed by the name of the reports in which it is recorded. Since 1990, the ECRs have been divided into two parts. For current purposes, Part I will include the judgments of the ECJ and Part II will include the judgments of the CFI. Prior to 1990 there were no parts, and so there will be no reference to them in cases before this date. Report names are followed by the page reference, which will be to the first page of the report concerning the case.

Thus,

Case T-185/94 *Geotronics v Commission* (“*Geotronics*”) [1995] ECR II-2795

refers to the 185th case lodged with the CFI in 1994; it was brought by Geotronics against the Commission and the judgment was reported in 1995 in Part II of the ECR at page 2795; and

Case C-395/95 *Geotronics v Commission* [1997] ECR I-2271

refers to the 395th case lodged with the ECJ in 1995; it was brought by Geotronics as appellant against the Commission and the judgment was reported in 1997 in Part I of the ECR at page 2271.

These references are to the date of the report in the ECR, not to the date of the judgment. That will appear on the first page of the relevant report, but the report will generally be published some time after the judgment has been delivered.

4.2 READING THE CASE

It is important to bear in mind that the ECJ is made up of judges and Advocates General who have the same status as judges. Understanding their separate functions will assist in understanding the case reports.

When a case is received by the ECJ Registry, it will be assigned to one of the judges acting as a reporting judge (*a juge rapporteur*). His function is to provide an extensive statement of facts and the arguments of the parties, known as the Report for the Hearing.

The role of the Advocate General (AG) is to make a reasoned submission on the cases in order to assist the ECJ. The AG’s submission, which is made in open court, is known as an Opinion. It is in this Opinion that readers will find a full discussion of facts, reference to relevant legal provisions, and a full consideration of the previous decisions of the ECJ. This Opinion is not binding on the ECJ; it is only an opinion, but a very valuable one. In many cases, the ECJ follows the AG fully; in others, it deviates from the Opinion either wholly or in part. It is probably best to view the AG’s Opinion as a starting point or reference point for the ECJ’s deliberations.

Following the written submissions of the parties, the Report for the Hearing, any oral hearings and the AG's opinion, the ECJ will begin its deliberations. These deliberations are generally conducted in French, the ECJ's working language (even though it is not the mother tongue of all or even a majority of the judges). Once the ECJ have reached agreement, the judgment is translated into the language of the case and signed by the judges. The judgment is a single concurring decision and does not contain any dissenting judgments or opinions. It is, in effect, a committee decision. For this reason, it is often possible to discern more than one line of reasoning in the judgment leading to the same conclusion. In some cases, it might appear that something is missing – this is usually the result of having removed certain statements or arguments that displease judges otherwise minded to dissent from the collective view.

As a result, the judgments tend to be rather terse and formalistic, and are not as discursive as, for example, those of common law countries. They are often less easy to read than the Opinions of the AGs, who have greater flexibility in exploring the issues and possible lines of reasoning.

When reported, the judgment will consist of three main parts: the Report for the Hearing, the ECJ's reasoning, and the actual ruling. The second part is the most important, but for the reasons set out above it tends to be less readable than the AG's Opinion. The final section, the operative part of the judgment, contains the ruling of the ECJ – generally a short statement.

The Opinion of the AG will also be attached.

4.3 RELIANCE ON PREVIOUS CASE LAW

In terms of a system of legal precedent, there is no doctrine at Community level of *stare decisis*, which would require the ECJ to follow its previous case law. However, the ECJ does tend to follow its previous decisions in almost all cases. This was less evident in older cases, but the ECJ has now started to make extensive reference to earlier case law. Unlike common law systems, however, it tends to refer to more recent earlier cases rather than seeking out the oldest cases.

There are, of course, instances where the ECJ does not follow its previous case law. Generally, however, in such instances it does not refer to previous cases with which it disagrees, either because of changed circumstances or because the ECJ has effectively changed its mind. It just ignores them, making it difficult sometimes to track any changes in policy. This is where the Opinions of the AGs come into their own since they will often contain a consideration of the previous case law and indicate any proposed or potential divergences.

MODULE
A

Introduction
and principles

PART
2

Institutional
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SECTION
4

Finding and using
the cases of the
European Court of Justice

4.4 FINDING CASES

The obvious place to search for reported cases is in the European Court Reports themselves. These are available by subscription from the Office of Official Publications. The ECJ's decisions are also available on the ECJ's own website: www.curia.eu.int

Notifications of cases and short summaries are also found in the "C" series of the Official Journal. This is available by subscription from the Office of Official Publications, but copies are also available on the Community's official Europa website: <http://eur-lex.europa.eu/en/index.htm>.

Infringement proceedings are also tracked by DG Markt on their website:

http://ec.europa.eu/internal_market/publicprocurement/infringements_en.htm.

Copies of the Opinions of the AG and the judgments of the ECJ are also available on the day of delivery at the ECJ itself in Luxembourg.

[Localisation: In XXX, it is also possible to access these cases through the XXX website]

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SECTION 5 CHAPTER SUMMARY

SELF-TEST QUESTIONS

1. What is the responsibility of contracting entities?
2. Who is the Community legislator?
3. What is the critical power of the European Commission when it comes to legislation?
4. What other roles does the European Commission have?
5. What is the role of the member states in the legislative process?
6. Why are they sometimes held responsible for the actions of contracting entities?
You may also want to consider module A1.
7. Name the two primary European Courts for our purposes.
8. What do you understand by the function of preliminary rulings of the Court?
9. Explain the phrase "general principles of law".
10. How is Community legislation implemented in XXX?
11. How is Community legislation enforced in XXX?
12. XXXX etc localisation required?

Legislative framework and basic principles of public procurement

MODULE A

Historical context

PART 3

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SECTION 1 INTRODUCTION

1.1 OBJECTIVES

The objectives of this chapter are to explore, explain and understand:

- The context in which the procurement system of the EC was developed
- The history of that development
- The objectives at the heart of this system of regulation and where it has evolved, and
- How the EU system differs from other “systems” of procurement regulation

1.2 IMPORTANT ISSUES

The most important issues in this chapter are understanding:

- The principles that govern the regulation of public procurement in the EC
- The particular objectives of the EC that led to the development of the legislation
- The way in which the EC context has moulded the procurement regulation.

It is therefore critical to understand fully:

- The objectives of the EC Treaties
- The ensuing objectives of the Procurement Directives, and
- The objectives of other procurement systems

1.3 LINKS

There is a particularly strong link between this chapter and the following module:

- Module A1 on the basic principles of public procurement

1.4 RELEVANCE

This information will be of interest to all persons involved in procurement who wish to understand the objectives of the procurement legislation and follow its development from its beginnings. It is also of particular relevance to procurement professionals seeking to interpret provisions of the Directives that may be unclear if read out of context.

MODULE
A

Introduction
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3

Historical context

SECTION
1

Introduction

1.5 **LEGAL INFORMATION HELPFUL TO HAVE TO HAND**

In addition to referring to the EU legislative framework, it may be useful to have to hand the procurement rules developed in other contexts. These might include, for example:

- (i) rules contained in the UNCITRAL Model Law: to be found at http://www.uncitral.org/uncitral/en/uncitral_texts/procurement_infrastructure.html
- (ii) the rules of the WTO's Government Procurement Agreement (GPA): to be found at http://www.wto.org/english/tratop_e/gproc_e/gproc_e.htm
- (iii) the rules of the World Bank: to be found at <http://web.worldbank.org/WBSITE/EXTERNAL/PROJECTS/PROCUREMENT/0,,contentMDK:50002392~menuPK:93977~pagePK:84269~piPK:60001558~theSitePK:84266,00.html>
- (iv) the rules of the EBRD: to be found at <http://www.ebrd.com/about/policies/procure/index.htm>

SECTION 2 NARRATIVE

2.1 INTRODUCTION

The primary purpose of this module is to provide an historical context to the procurement Directives. However, this cannot be done without also considering the political and economic context within which the Directives have been developed. That context relates in particular to the purposes of the Directives, which are bound to the purposes and objectives of the European Community. The procurement Directives take on the particular flavour of the Community context, and the rules contained in them reflect the objectives of the Community itself. While the provisions of the Directives are superficially very similar to the provisions found in other systems of procurement regulation, the motivation for their adoption is Community-specific.

It is of course not surprising that all systems use very similar provisions – there has been no need to “reinvent the wheel”. Procurement regulation existed well before the establishment of the European Community or the World Trade Organisation (WTO), and many countries, including a number of member states, already had sophisticated domestic systems. Procurement is not an invention of the European Community. Furthermore, the Organisation for Economic Co-operation and Development (OECD) had been working on the identification of procurement procedures among its members as early as the 1960s, and the results were contained in an OECD Report published in 1966. There was significant cross-fertilisation between the work of the OECD and that of the EEC (as it then was), at the time when the latter was developing its procurement regime. The work of the OECD also informed the international negotiations that were taking place at the level of the General Agreement on Tariffs and Trade – GATT (now the WTO).

At the same time, the existence of domestic procurement legislation was a key motivator for the creation of procurement legislation at Community level, because it was often used as a means of providing domestic preferences of one sort or another. Given the primary objective of the European Community, such national preferences and differences had the potential to disrupt the very goals of the Community. It was with this in mind that, at the outset at least, the Community Legislator began the process of developing and expanding its own procurement system. As time passed, other objectives were added, notably the pursuit of secondary Community objectives that foster social and environmental policies, but the core objectives of the Community procurement system has always been to create a common procurement market free of national preference and bias.

Article 2 of the Treaty of Rome (original text)

“The Community shall have as its task, by establishing a common market and progressively approximating the economic policies of member states, to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, an increase in stability, an accelerated raising of the standard of living and closer relations between the States belonging to it.”

Other procurement systems that rely on similar terminology have different objectives and are thus drafted and implemented slightly differently, with the result that the various systems are not always identical in their goals, methods, implementation or interpretation. To facilitate understanding of the distinction between the various systems, Section 2.3 below will set out briefly the objectives and core requirements of other systems of procurement.

2.2. DEVELOPMENT OF THE EU PROCUREMENT SYSTEM

2.2.1. The Treaty framework

As indicated in module A1, the Treaty of Rome (as well as the subsequent treaties amending the Treaty of Rome) – hereafter referred to as “the Treaty” – does not include any explicit provisions relating to public procurement.

The Treaty is a framework treaty, setting out the main principles to be applied and leaving the detailed implementation to later secondary legislation. The procurement rules have largely been the product of secondary legislation, adopted by way of the Directives.

The silence of the Treaty in respect of procurement may also be the result of the failure of the negotiators of the Treaty to reach agreement on such a complex issue, characterised by considerable differences in national procurement systems and by the extreme sensitivity connected to preferential procurement practices. It is also possible that the issue of non-tariff barriers to trade (such as preferential procurement practices) was not as critical at that time as the abolition of tariff barriers to trade.

Module A1 also discusses the way in which a number of provisions of the Treaty affect public procurement directly, even if they are not mentioned explicitly. In respect of procurement, the core freedoms are crucial and have underpinned the development of secondary procurement legislation from the 1960s to today. Two of those freedoms, in particular, have been fundamental in the development of the procurement Directives: the free movement of goods and the freedom to provide services.

In addition to these principles, the ECJ has also developed a series of additional “general principles of law”, which are ultimately derived either from the Treaty or from the legal systems of the member states. The ECJ has been content to apply both of these types of principles to the field of public procurement in the absence of explicit provisions. Such principles have subsequently often found their way into the Directives themselves, and their impact can be seen in the later iterations of the Directives.

2.2.2. The General Programmes

Explicit Community intervention in procurement began with two General Programmes, which dealt with the lifting of restrictions in public works contracts. These programmes demonstrated at an early stage the concern of the Community with discrimination in the field of procurement. They only dealt with public works contracts since they were adopted under the provisions relating to the freedom of establishment and the freedom to provide services, and did not concern the supply of goods, which for Community purposes falls under the provisions relating to the free movement of goods.

Both programmes required the elimination of restrictions – including rules and practices of member states with respect to foreigners – , which exclude, limit or impose conditions upon the capacity to submit offers or to participate, whether as contractor or subcontractor, in contracts awarded by the state or other legal persons governed by public law.

These were transitional provisions, and the restrictions were to be removed by the end of the transition period.

With some foresight, both General Programmes stated that the elimination of discrimination and restrictions in the field of procurement would need to be accompanied by measures to co-ordinate the procurement procedures of the member states.

2.2.3 The early Directives

The General Programmes were implemented by way of a series of subsequent Directives. These Directives were of two types, referred to as the Liberalisation Directives and the Co-ordination Directives.

The **Liberalisation Directives** were used to eliminate restrictions and discriminatory measures.

The **Co-ordination Directives** were aimed at the approximation of the laws of member states, and in the case of procurement, at the co-ordination of national contract award procedures.

2.2.3.1 Liberalisation Directives

Three general Liberalisation Directives were adopted in 1964 in an attempt to implement the General Programmes: **Directives 64/427, 64/428 and 64/429**.

The first two Directives imposed an immediate prohibition on the restrictions identified in the General Programmes. In the case of public procurement, this meant a prohibition on national measures excluding, limiting or imposing conditions on foreigners in respect of the submission of offers or participation, whether as contractor or subcontractor, in contracts awarded by the state or other legal persons governed by public law. In respect of procurement, Directive 64/428 provided that, in demonstrating technical capacity, certificates relating to the completion of works contracts in the territory of other member states would have equal value to those referring to works carried out in the host member state.

Following a proposal dating from 1964, the Council adopted its first Liberalisation Directive, aimed specifically at removing restrictions to the freedom of establishment and the freedom to provide services in the area of works contracts. This was **Directive 71/304, the first Works Directive**.

This Directive called again for the immediate abolition of the restrictions contained in Title III of the General Programmes and set out in greater detail the types of discrimination that were prohibited, including (in article 3(c)) those national measures that had been applied irrespective of nationality but which nonetheless hindered exclusively or principally the activities of nationals of other member states.

In the case of supplies, the first Directive specifically to address public procurement was **Directive 70/32**. It was, however, adopted shortly before the end of the transition period and is mainly of interpretative value.

The Directive applied to all nature of goods supplied to the state, regional and local authorities and to legal persons governed by public law, including the supply of products necessary for the completion of building works, whether or not these goods were an integral part of a public works contract. The aim of the Directive was to require member states to apply the provisions relating to the free movement of goods to all legislative, regulatory and administrative provisions as well as to administrative practices that totally or partially:

- (1) excluded the supply of imported products;
- (2) protected or granted preference to national products (other than those provided by way of state aid); or
- (3) placed imported products at a disadvantage other than by means of a tax.

The Directive also contained a list of typical forms of discrimination that were targeted for abolition. These included, for example, differential treatment with respect to the provision of securities and deposits and the practice of making the supply of imported products conditional on reciprocity granted by the member state from which the products were imported.

The Directive further prohibited indistinctly applicable technical specifications that had restrictive effects that were out of proportion to the goals sought and that could have been achieved by means of less restrictive trade.

In the case of both supplies and works, therefore, the Liberalisation Directives applied the principles relating to the free movement of goods, the freedom of establishment and the freedom to provide services.

The Liberalisation Directives were based on the specific Treaty provisions aimed at removing obvious cases of discrimination. As recognised in the General Programmes, however, the removal of formal instances of discrimination needed to be accompanied by further positive measures designed to co-ordinate the various procurement procedures of the member states.

The subsequent Co-ordination Directives were thus based on Treaty provisions designed for the approximation of those laws, regulations or administrative actions in the member states that directly affected the establishment or functioning of the common market.

2.2.3.2 Co-ordination Directives

Two Co-ordination Directives were adopted in succession:

- Directive 71/305 on public works contracts; and
- Directive 77/62 on public supplies contracts.

This separation between public works and public supplies contracts was probably explained by the different legal bases upon which the earlier Directives had been adopted and cited in the recitals to the Directives. The provisions of both Directives were largely the same, but they remained separate until 2004 when they, together with a later Directive concerning public services contracts, were consolidated into a single text.

Directive 71/305 was adopted following the two General Programmes, with the purpose of co-ordinating the national award procedures of member states in respect of the award of their public works contracts. Recital 3 of the Directive restates the main objectives of the General Programmes as the prohibition of technical specifications that have a discriminatory effect, adequate advertising of contracts, and the fixing of objective criteria for participation. In recital 9, the Directive places particular emphasis on the development of effective competition in the area of public contracts for which advertisement is necessary throughout the Community. The purpose was to provide economic operators established in the Community with adequate information to enable them to decide whether such contracts were of interest to them.

Directive 77/62 was adopted with a view to supplementing the prohibition contained in article 30 of the Treaty through the co-ordination of procedures relating to public supply contracts. The Directive reiterates the core objectives of Directive 71/305 and, in recital 2, emphasises that the Directive is necessary “in order, by introducing equal conditions of competition for such contracts in all member states, to ensure a degree of transparency allowing observance of this prohibition to be better supervised”. The key mechanism of both Directives is thus to impose Community-wide advertising of public contracts that will (1) provide effective competition by ensuring equality of opportunity (by notifying tenderers in all member states of contracts to be let throughout the Community) and equal access to those contracts (by fixing objective criteria for participation and prohibiting the use of discriminatory technical specifications); and (2) guarantee a degree of transparency enabling supervision.

It should be added that, as co-ordination measures, the Directives do not seek to impose a new common regulatory regime on member states. Recital 2 of Directive 71/305 indicates that the co-ordination effort should take into account as far as possible the procedures and administrative practices in force in each member state. Article 2 of both Directives makes it clear that the authorities awarding contracts are to apply their national procedures *adapted* to the Directives. The Directives thus limit their scope to those measures required for the co-ordination exercise and permit member states to maintain or adopt substantive and procedural rules, to the extent that these are not in conflict with the Directives or with Treaty provisions.

Furthermore, the Directives applied only to proposed procurement contracts of a financial value above a given threshold (1m units of account in the case of works and 200,000 units of account in the case of supplies). These were the contracts that were most clearly capable of having an impact on competition (recital 1) and of affecting trade between member states.

2.2.4 Directives following the Single European Act

A series of communications prepared by the European Commission concerning the implementation of these early Directives revealed the disappointing results achieved. As well as expressing its criticism of the member states' failure to effectively and fully implement the Directives in national law, the Commission identified a number of factors that were of particular concern:

- the limited coverage of the Directives as a result of the exclusion in the previous Directives of the utilities sectors, *i.e.* public and or private entities operating in the sectors of water, energy, transport and telecommunications;
- the limited effect due to the level of the thresholds, notably because contracting authorities brought a high proportion of contracts below the thresholds by underestimating contract values and by an excessive division of projects into lots, with a view to avoiding application of the Directives;
- the infrequent use of the open procedure, with more reliance placed on non-competitive procedures;
- the absence of any enforcement mechanisms that would bolster the implementation of the Directives.

To achieve completion of the common market, the Single European Act (SEA) provided a new legal base, and the Procurement Directives adopted following the SEA were based on the new article 100a (now article 95), which permitted the Council to adopt, by qualified majority, measures for the approximation of the provisions laid down by law, regulation or administrative action in member states that had as their object the establishment and functioning of the internal market.

Broadly, two initiatives were taken: first, to improve the existing Directives and second, to extend the scope of the Directives and rationalise the growing number of applicable documents.

2.2.4.1 Improvement measures

Amendments were made to:

- the Works Directive by Directive 89/440; and
- the Supplies Directive by Directive 88/295.

The main thrust of these amendments, as set out in recital 6 to Directive 89/440 and reflected in recital 5 to Directive 88/295, was to "guarantee real freedom of establishment and freedom to provide services in the market for public works contracts" by improving and extending "the safeguards in the directives that are designed to introduce transparency into the procedures and practices for the award of such contracts in order to be able to monitor compliance with the prohibition of restrictions more closely and at the same time to reduce disparities in the competitive conditions faced by nationals of different member states."

Increased transparency effectively meant an improvement of the advertising rules and of the information to be made available in order to allow for better supervision and monitoring. The Directives introduced:

- a new requirement to publish prior information notices (PINs), by which contracting authorities would indicate their intended purchases for the coming budgetary year and would, in return, be permitted to reduce the minimum time limits set out in the Directives to be observed between the call for competition and the submission of bids;
- a further measure to improve the flow of information by requiring the publication of a contract award notice and a debriefing of unsuccessful tenderers upon request;
- mandatory references to European standards in order to further reduce the disparities in the competitive conditions faced by foreign tenderers;
- a stricter approach to the contract award procedures to be used, together with an extension of the minimum time limits;
- a negotiated procedure simply for those circumstances in which the original Directives no longer applied.

Furthermore, in cases not falling within the conditions enumerated for use of the negotiated procedure, the use of the open or restricted procedure was made the rule in the case of works. In the case of supplies, the open procedure was made the rule, with the use of a restricted procedure requiring justification based on either the need to maintain a balance between contract value and procedural costs or the specific nature of the products to be procured. This provision was later removed.

In addition, the threshold level for works contracts was increased to ECU 5 million “in view of the rise in the cost of construction work and the interest of small and medium-sized firms in bidding for medium-sized contracts”.

2.2.4.2 Extension and rationalisation

In terms of works and supplies, the next major step was the consolidation of the various amendments into two new Directives: 93/36 and 93/37. The preambles reflect those of previous Directives, although the term transparency is now largely replaced by references to the provision of information.

In addition, the period following the SEA witnessed the adoption of four new Directives:

- **Directive 89/665** on remedies in the public sector and **Directive 92/13** on remedies in the utilities sector

The lack of enforcement measures had been identified by the Commission as an obstacle to the effective implementation of the procurement Directives. The provisions of the Public Sector Remedies Directive were largely reproduced for the utilities sector in Directive 92/13, although this Directive also took account of the greater flexibility afforded to the utilities sector and contains some additional provisions, introducing both an attestation system and a conciliation procedure. These Remedies Directives have now been amended.

- **Directive 90/531** on the award of public works, supplies and services contracts by entities operating in the utilities sector

The utilities sector was excluded from the original public procurement regime largely as a result of the identity of the contracting authorities and entities operating in the sector (often private undertakings). This situation is discussed further in module D2. With the adoption of the original Utilities Directive, these entities were brought within the regime under certain conditions and were subject to a rather more flexible set of procedures so as to take account of the more commercial environment within which they operated.

- **Directive 92/50** on public (non-construction) services contracts

The procedural provisions of the Services Directive are almost identical to those of the Supplies Directive, except that they have been adapted to the particularities of services contracts. It was based on the Treaty provisions concerning the freedom of establishment and the freedom to provide services. The only significant difference is that the Services Directive applies two levels of provisions depending on the type of services concerned (see module D3). Only a small number of provisions relating to the use of non-discriminatory technical specifications and the obligation to publish a contract award notice apply to non-priority services, which are those where the full potential for increased cross-frontier trade will not be realised.

2.2.5 The new Consolidated Directives

Reform of the Directives discussed above was under serious consideration from as early as the Commission's Green Paper of November 1996, which was followed by its 1998 Communication on Public Procurement in the European Union. This reform resulted in proposals for two new Directives, one for the public sector and the other for the utilities sector. Following a number of amendments and after intense debate with the European Parliament, these proposals finally became Directives in January 2004. They were adopted against the background of the developments of the Treaty itself, which are also reflected in the new Directives. These two Directives form the essential subject matter of this training.

The most obvious change in the public sector was the consolidation of the previous three Directives applying to contract award procedures for public works, supplies and services, respectively, into a single new Directive. Along with this consolidation exercise, the new public sector Directive was simplified and streamlined, and it now shows a greater degree of procedural logic.

To a very large extent, the amendments brought to the new Utilities Directive mirrored those made to the new *single* public sector Directive.

In clarifying the existing provisions, however, the Legislator also took the opportunity of bringing about some significant as well as more minor changes to the substance of the Directives. Some of these changes merely reflect the ECJ's evolving case law in respect of public procurement matters or recognise the reality of national procurement practices.

The public sector Directive nevertheless does introduce some novel provisions, some of which are also reflected in the Utilities Directive. In summary, the main amendments to the public sector procurement regime are as follows:

- recognition that a number of contracting authorities may conduct centralised procurement;
- explicit acceptance of the use of framework agreements, albeit subject to the conditions set out in the Directive (these had already been permitted in the existing Utilities Directive);
- amendments to the provisions relating to technical specifications that removed the obligatory use of references to European standards;
- introduction of a new competitive dialogue procedure in situations where procuring entities cannot either define the technical means to meet their needs or specify the contractual or financial make-up of the project (this amendment was not extended to the new Utilities Directive);
- introduction of electronic procurement mechanisms, including electronic auctions, dynamic purchasing systems, and reduction of the relevant time limits in the event of electronic communications;
- explicit approval of the use of social and environmental considerations in the setting of specifications, selection and award criteria, and application of contract conditions, as well as provision for procurement from sheltered workshops;
- introduction of new requirements for minimum qualification and relative weighting of selection and award criteria that are to be disclosed in advance.

In addition to introducing consistency with the public sector Directive, the new Utilities Directive also brings about some significant changes that are specific to the utilities sector. Some of the more minor amendments concern the information that must now be supplied to tenderers by *all* procuring entities and not only those subject to the WTO's Government Procurement Agreement (GPA) (art. 49); the introduction of the general principle of mutual recognition for all procedures and not only in the case of the qualification procedure (art. 52); and the amendments to the provisions on design contests, ensuring that all of the general exemptions also apply (art. 62).

The more significant amendments include:

- exclusion from the scope of the Directive of entities operating in the telecommunications sector;
- inclusion of entities operating in the postal services sector;
- introduction of a general mechanism that would permit the exclusion of those entities that can demonstrate their operation in competitive markets;
- amendment to the definition of special or exclusive rights so as to align it with the jurisprudence of the ECJ;
- revision of the threshold values to counter the problems of varying thresholds brought about by the GPA;
- extension of the affiliated undertakings exemption to include works and supplies contracts.

2.2.6 Recent developments

There have been two recent developments:

Directive 2007/66/EC, which significantly amends the two Remedies Directives in the public and utilities sectors, respectively. The Directive introduces, *inter alia*, a standstill provision between the award and conclusion of a contract, allowing tenderers time to bring proceedings in the event of perceived breaches of the Directives. The deadline for implementation was 20 December 2009.

Directive 2009/81, which now applies a more flexible and confidential regime to the procurement of *military supplies and related works and services*, which were previously excluded from the public sector Directive. All other public contracts awarded in the fields of defence and security remain covered by the public sector Directive.

2.3 OTHER PROCUREMENT SYSTEMS

This section briefly considers a number of other “international” procurement systems: the WTO’s Government Procurement Agreement (GPA); the UNCITRAL Model Law; and the Procurement Guidelines of the Multilateral Development Banks (MDBs), taking the examples of the World Bank and the EBRD.

In general terms, only one of these, the WTO’s GPA, has a direct impact on the EU procurement system due to the EU’s membership of the GPA on behalf of all EU Member States. As a result, the GPA applies to public procurement in the member states. However, since the procurement Directives have been amended to take account of the GPA requirements, compliance with the Directives will also signify compliance with the GPA, and therefore no specific further action is required.

The UNCITRAL Model Law may have an indirect impact, however, since it has been used on occasion as a model for procurement reform in countries acceding to the EU. The result is that some provisions of national law reflect the wording and intent of the UNCITRAL Model Law and have only subsequently been amended to bring them into line with EU requirements. [Localisation required where target country originally based its procurement law on the UNCITRAL Model Law: This is the case in XXX, where (provide a description of the process with reference to section 2.4)]

2.3.1 The GPA

The Government Procurement Agreement (GPA) is the procurement regulation of the World Trade Organisation (WTO). It provides an international system of procurement regulation in the sense that it imposes obligations on the signatory states, which much provide access to their procurement markets to tenderers from other signatory states. As with the European Community, the GPA seeks to set up a procurement market between the members of the agreement, to which all members have equal access.

The current GPA dates from 1994 and is part of the Uruguay Round of international trade negotiations held under the auspices of the General Agreement on Tariffs and Trade (GATT), which led to the creation of the World Trade Organisation (WTO). The GPA of 1994 replaced the earlier GPA (1979), which had been amended in 1987.

This new GPA has an expanded scope and now covers not only central government but also sub-central government entities and some utilities. It covers goods and also some services, including construction services. It further contains a bid-challenge mechanism, which allows disappointed tenderers to invoke the GPA before national courts.

The stated objective of the GPA (1994), as set out in its preamble, is to provide an effective and transparent multilateral framework of rights and obligations with respect to laws, regulations, procedures and practices regarding government procurement. The aim is to achieve greater liberalisation and expansion of world trade and to improving the international framework for the conduct of world trade.

The GPA provides this framework, in theory, by extending the GATT principles of non-discrimination (Most Favoured Nation and national treatment) to the tendering procedures adopted by government bodies at both central and regional levels as well as to the tendering procedures of other specified entities. However, this extension of the GATT principles is not complete.

- First, the GPA is one of the “plurilateral” agreements under the WTO umbrella, signifying that only those states that have signed the agreement are bound by it. It does not apply between all of the members of the WTO.
- Second, the non-discrimination obligations do not apply to all government procurement of the signatories. Rather, they apply in a qualified manner to specified entities, goods and services that have been the subject of extensive bilateral negotiations between the signatories.

The results of these bilateral negotiations are contained in a series of annexes to the GPA, which are critical to an understanding of the true scope of application of the GPA. Coverage is not uniform between all of the parties, and this is also true of the European Community. For example, the benefits of the GPA are not extended by the Community to Canada in respect of bodies governed by public law. Similarly, until such time as reciprocal access is given to Community suppliers and service providers, the European Community will not extend the benefits of the GPA to, for example, Canada and the United States in respect of water activities; Canada and Japan in respect of electricity activities; and Canada, Korea and the United States in respect of airport terminal facilities.

In respect of access therefore (as opposed to compliance), the GPA annexes will be critical.

As with the European Community provisions, implementation of the basic obligations of non-discrimination by the GPA signatories is ensured by setting out a number of detailed operational rules for tendering to be followed by procuring entities. This is done by prescribing three methods of tendering (open, selective and limited) and one additional mechanism, which may be applied to each of those methods (competitive negotiation), supplemented by provisions relating to the preparation of tender documentation, qualification of suppliers, selection procedures, receipt and opening of tenders, and award of contracts. In addition, the rules provide transparency requirements relating to tender notices and their publication, time limits for tendering and delivery, and information on the award of contracts. The GPA also contains specific rules with regard to technical specifications.

As with the Community rules, the GPA does not seek to replace national procurement systems but sets out a requirement of consistency between the applicable national systems and the GPA. As a result, the national procurement systems of the parties have been modified to a greater or lesser extent in order to bring them into line with the GPA. This modification might pose some difficulty for EU member states, which would thus need to adapt their national legislation to the requirements of both the procurement Directives and the GPA.

However, the Community Legislator has amended the Directives with a view to ensuring compliance of the Directives with the GPA. The latest Directives, in particular, amend the threshold levels so as to provide consistency between the application of the Directives and the application of the GPA. Since the two sets of provisions are considered to be consistent (if not identical), the Commission considers that if contracting entities covered by the Agreement comply with the Directives and apply them to economic operators of third countries that are signatories to the Agreement, they “*should* therefore be in conformity with the Agreement”.

Compliance with the Directives is thus considered to be sufficient and to equate with compliance with the GPA. The only readily apparent difference in application consists of the different threshold values that apply to contracts for goods and services awarded by central government authorities (listed in annex IV of the GPA) and the differential treatment accorded to certain defence products and services. Otherwise, specific compliance with the GPA is not necessary.

All contracting authorities that are public authorities for the purposes of the public sector Directive, namely public authorities and bodies governed by public law, are also covered by the GPA (the annex to the Directive sets out the coverage of each signatory).

In the case of the utilities sector, only contracting authorities and public undertakings are covered, and not those entities operating on the basis of special or exclusive rights, which operate in defined activities. Even then, not all of the utilities sectors are covered. Entity coverage was based on the idea of reciprocity, so that each member would offer to the other members *equivalent* access to its government procurement in proportion to its size and to the size of the economy as a whole based on negotiations.

In the case of the utility sectors in the European Community, the Community negotiated access to the contracts let only by public authorities and public undertakings defined in the Utilities Directive, where they carry out one or more activities in the areas of water, electricity, urban transport, and terminal facilities in ports and airports. In the case of the European Community, the GPA does not apply to activities in the areas of gas and heat, extraction of oil, gas and solid fuels, transport by railway (other than urban railway), or telecommunications.

2.3.2 The UNCITRAL Model Law

UNCITRAL is the United Nations Commission on International Trade Law. It was established in 1966 in recognition of the disparities in national laws governing international trade, which create obstacles to the flow of trade, as identified by the General Assembly of the United Nations. UNCITRAL was given the general mandate to further the progressive harmonisation and unification of the law governing international trade. Among its achievements has been the adoption of a Model Law on the Procurement of Goods, Construction and Services. The Model Law was first adopted for goods and construction in 1993 and for other services in 1994. It is currently under review.

As the title suggests, it is intended as a model law; it is not itself a law or regulation. It is intended to serve as a model to enable states to evaluate and modernise their procurement laws and practices and to establish procurement legislation where none currently exists.

Article 3 of the Guide to Enactment

The decision to adopt the UNCITRAL Model Law was taken “in response to the fact that in a number of countries the existing legislation governing procurement is inadequate or outdated. This results in inefficiency and ineffectiveness in the procurement process, patterns of abuse, and the failure of the public purchaser to obtain adequate value in return for the expenditure of public funds. While sound laws and practices for public sector procurement are necessary in all countries, this need is particularly felt in many developing countries, as well as in countries whose economies are in transition. In those countries, a substantial portion of all procurement is engaged in by the public sector. Much of such procurement is in connection with projects that are part of the essential process of economic and social development. Those countries in particular suffer from a shortage of public funds to be used for procurement. It is thus critical that procurement be carried out in the most advantageous way possible.”

The Guide to Enactment makes it clear that the objectives of the Model Law – which include maximising competition, according fair treatment to suppliers and contractors bidding to do government work, and enhancing transparency and objectivity – are essential for fostering economy and efficiency in procurement and for curbing abuses. These are essentially economic objectives and there is no explicit intention, as in the case of the European Community or WTO, of creating any international system of procurement that regulates procurement between the parties to the agreement (*i.e.* EU member states or signatories of the GPA).

It is, by definition, a model that may be used to guide the development of domestic systems of regulation. The resulting regulations will be domestic, not international, even though one of the stated purposes of the Model is to foster international trade. The Model nevertheless does also have a generalised objective of harmonising domestic systems with a view to facilitating international procurement and the accession to international procurement systems.

As already mentioned above, a number of countries that acceded more recently to the EU had originally developed procurement legislation based on the UNCITRAL Model Law. To a large extent this was a positive move, since it enabled those countries to begin the process of reform on the basis of the pursuit of economy and efficiency in procurement at a time when procurement from the market economy was relatively novel.

The EU accession process required more, however, since its primary objectives were not economic (in the sense of economic efficiency) but political, in the sense that they were designed to establish and maintain a common procurement market within the Community. UNCITRAL-based domestic legislation thus required amendment to align it with the goals of Community procurement legislation. [Localisation required where target country originally based its procurement law on the UNCITRAL Model Law: In the case of XXX, this process can be seen in certain articles of the XXX, such as...]

2.3.3 Procurement rules of the multilateral development banks

The third type of procurement regulation of interest concerns the procurement rules of the multilateral development banks (MDBs). As will be mentioned in module D4, the Directives do not apply to contracts that are governed by different procedural rules and awarded, *inter alia*, pursuant to the particular procedure of an international organisation. This exclusion includes the procedures of the MDBs.

These procedures are formal rules that have been developed by various international organisations (not only the MDBs, but also the United Nations, European Investment Bank, the Commission through the Practical Guide [PRAG], OPEC, bilateral donors, etc.) to govern procurement benefitting from aid to state projects. The aid may be in the form of loans, grants or other assistance, and it is given to countries by the MDBs and other organisations for projects of all sorts, but notably for infrastructure projects.

While the procurement procedures connected with these projects are generally conducted by the beneficiary states as executing agencies, the donors generally maintain some form of supervision over the procurement. The purpose of such supervision is to ensure that the money is used efficiently and effectively and for the purposes that it was given.

Example of purpose of the European Bank for Reconstruction and Development's PP&R (Article 13 of the Agreement Establishing the EBRD)

"(xiii) the Bank shall take the necessary measures to ensure that the proceeds of any loan made, guaranteed or participated in by the Bank, or any equity investment, are used only for the purposes for which the loan or equity investment was granted and with due attention to considerations of economy and efficiency."

The supervision may well include prior and post review and the requirement to obtain "no-objections" from the donor institutions before actions are taken, but it will frequently also take the form of a set of procurement rules or guidelines that govern the whole procurement process. This is notably the case for the MDBs.

Thus, the World Bank (as well as, *e.g.*, the Asian Development Bank, African Development Bank and Inter-American Development Bank) maintains a set of Procurement Guidelines for the procurement of goods and works and for the selection of consultants, and the EBRD maintains its Procurement Policies and Rules.

These procedures will also often contain sets of standard tendering and contract documents based on international models (such as the FIDIC Works contracts) or on harmonised documents agreed between the MDBs, thereby providing a complete assistance package to the beneficiaries in the conduct of their procurement.

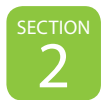
In many developing and transition countries, some of which have since acceded to the EU, national procurement legislation has also drawn inspiration from such procedures. Notable here is the case of the World Bank, which has sometimes required the adoption of modern procurement laws (frequently modelled on its own Procurement Guidelines) as a condition for granting aid or loans. This has clearly had a beneficial effect since, like the UNCITRAL Model Law, these guidelines are largely based on the principles of economy and efficiency and do not have overtly political objectives. However, as with national laws originally based on the UNCITRAL Model Law, some amendment will have been necessary to align those laws with the requirements and objectives of the procurement Directives.



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2.4 HISTORY OF THE NATIONAL PROCUREMENT SYSTEM

Full localisation required.

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SECTION 3 EXERCISES

EXERCISE 1 OBJECTIVES OF PROCUREMENT REGULATION

Carry out a website search of the procurement rules of the following institutions:

UNCITRAL Model Law:

http://www.uncitral.org/uncitral/en/uncitral_texts/procurement_infrastructure.html

WTO's Government Procurement Agreement (GPA):

http://www.wto.org/english/tratop_e/gproc_e/gproc_e.htm

World Bank:

<http://web.worldbank.org/WBSITE/EXTERNAL/PROJECTS/PROCUREMENT/0,,contentMDK:50002392~menuPK:93977~pagePK:84269~piPK:60001558~theSitePK:84266,00.html>

EBRD:

<http://www.ebrd.com/about/policies/procure/index.htm>

List the stated objectives of each of these "systems" and identify the common features. Compare these with those of the EC procurement Directives and list those objectives that do not appear in the latter.

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EXERCISE 2
NON-DISCRIMINATION

Using additional material from module A1, consider and explain how the principle of non-discrimination is used and applied in the EC and under the GPA.

Referring again to additional material from module A1, consider and explain how the principle of equal treatment is used and applied in the UNCITRAL Model Law and in the procedures of the World Bank and/or EBRD.

Explain how these principles are linked to the objectives of the procurement rules in question.

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EXERCISE 3
FLOWCHART OF PROCUREMENT LEGISLATION

Prepare a flowchart of the development of the procurement Directives from the General Programmes to today; it should include all relevant Directives to date.

SECTION 4

CHAPTER SUMMARY

SELF-TEST QUESTIONS

1. Provide a general explanation of the objectives of the European Community.
2. Explain how this is achieved through the procurement Directives.
3. Do all procurement systems share the same objectives?
4. Provide examples of objectives that are not or were not *explicitly* contained in the procurement Directives, and that you think are fundamental.
5. Explain the difference between liberalisation directives and co-ordination directives.
6. What was the impact of the Single European Act on the development of the procurement Directives?
7. Is there a reason of principle why the works, supplies and services rules were contained in separate Directives?
8. Apart from consolidation, what other changes were brought about to the structure of the rules in the consolidation Directives of 2004?
9. Name three other innovations of the consolidation Directives.
10. What are the goals of the WTO's Government Procurement Agreement (GPA)?
11. How are they different from those of the EU?
12. Is the UNCITRAL Model Law a system of procurement regulation?
13. How should it be used?
14. What are the goals of the UNCITRAL Model?
15. Explain the applicability of the procurement rules of the multilateral development banks (MDBs)
16. What are the goals of these procurement rules?
17. Do the rules and procedures of the MDBs offer any additional assistance to beneficiaries in terms of assistance with procurement?
18. Complete with questions about local historical development...

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SECTION 1 INTRODUCTION

Localisation: The structure and much of the commentary is generic but there will need to be adaptations for local use. The notes in green highlight areas where particular attention will need to be paid to local requirements. The notes in green are intended only as an aid to localisation and are not intended to be an exhaustive list of changes that will be required.

1.1 OBJECTIVES

The objectives of this chapter are to explore, explain and understand:

- The economic drivers and economic influences on public procurement decision making and processes

1.2 IMPORTANT ISSUES

The most important issues in this chapter are concerned with the need to ensure that you understand the impact of economic issues on:

- How to select the best approach to centralisation
- Procurement contracting strategies
- The use of e-auctions
- Whether and how to split contracts into lots
- The potential for collusive behaviour between economic operators

If this is not properly understood, you risk adopting approaches to procurement that will reduce the efficiency of the procurement process; that may have a negative impact on the quality and cost of the contract; and that may lead to collusive behaviour.

1.3 LINKS

There is a particularly strong link between this this section and the following modules or sections:

- Module C on preparation of procurement
- Module E on conducting the procurement process

1.4 RELEVANCE

This information will be of particular relevance to those procurement professionals who are responsible for procurement planning and scoping the requirements of contracting authorities.

Adapt for local use

Utilities

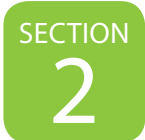
The same economic issues will apply for utilities.



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SECTION 2 NARRATIVE

Localisation: This module may require significant localisation, in particular if national legislation sets out the form of contract to be used by contracting authorities, whether and to what extent contracts can be divided into lots, and whether e-auctions are permitted or required.

Where national requirements differ significantly from the approaches outlined in module A4, it may be appropriate to retain A4 as drafted and to add a note indicating that a large portion of the module is for general reference purposes only.

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Choosing the appropriate
mixture of centralised
and decentralised public
procurement processes

SECTION 2A CHOOSING THE APPROPRIATE MIXTURE OF CENTRALISED AND DECENTRALISED PUBLIC PROCUREMENT PROCESSES

Localisation: Significant amendment to this section may be required if centralisation is either not permitted or if centralised arrangements are covered by local rules or laws.

OVERVIEW

In this section we will consider the economic arguments relating to the advantages and disadvantages of centralised public procurement. We will look at a range of issues, including how to design procurement processes so as to achieve better value-for-money, what circumstances lead to economies of scale, the role of information processing costs in public organisations, the link between the degree of demand aggregation, and the nature of competition for contracts.

2.1 INTRODUCTION

Effective procurement strategies, which control costs and streamline processes, are vital to all contracting authorities as well as to purchasers in the private sector. Pursuing the 'best value-for-money' in public (and private) procurement, while keeping the process management costs at bay, requires several crucial decisions.

In this section we will explore, from an economic perspective, the appropriate degree of centralisation and, in this context, the extent to which the demand by contracting authorities for works, goods and services should be aggregated.

In undertaking this analysis we will consider the two extreme ends of the spectrum of options that are available to contracting authorities – full centralisation and full decentralisation – whilst acknowledging that, in practice, the approaches adopted by contracting authorities fall between the two extremes and are often hybrid models in which aspects of both centralised and decentralised procurement coexist. Consequently, a more effective way of rephrasing the above question may be: what are the main forces influencing the 'optimal' mixture of centralised and decentralised procurement models?

Terminology: Readers should note that the term ‘centralised’ procurement in this context is not used as a synonym for procurement designed at a national level, and the term ‘decentralised’ procurement is not used as a synonym for locally designed procurement processes. The appropriate level of centralisation is a practical problem that might also arise within the same contracting authority, for example for a government ministry or department where several units would be able to spend public money independently of each other.

This section then examines the role played by the following factors in shaping the appropriate mixture of centralised and decentralised procurement processes:

- Efficiency through cost control
- Favouritism
- Strategic procurement
- Network effect and standards
- Emergencies
- Electronic procurement

It is important to note that although these factors are covered separately, they are closely interlinked so that it is artificial to evaluate the role played by each factor independently of all of the others.

2.2 EFFICIENCY THROUGH COST CONTROL

Cost control is a key issue in public (and private) procurement. Everywhere, contracting authorities need to control public spending. This is very often done by rationalising public spending for goods and services, which account for a considerable amount of resources. At government level, goods and services are generally perceived as ‘politically less sensitive’ targets for budget cuts than pension or health expenditure.

The issue of whether to centralise or decentralise will generally arise when an organisation or structure has reached a certain size and/or geographical presence. When organisations enlarge, controlling the costs of local structures becomes increasingly more difficult; clearly, this problem can be addressed by assigning budgets to decentralised units, although this measure would not necessarily imply efficient spending.

Centralisation may help to reduce purchasing costs considerably, which is mainly due to:

- Synergies (production economies of scale, avoiding effort/work duplication, reducing legal challenges)
- Increased specialisation
- Knowledge/resource-sharing

2.2.1 Synergies

The more standardised the product/service, the more potentially advantageous it is to the contracting authority to aggregate demand since economic operators are in a position to exploit economies of scale, thus operating at a lower unit cost.

Economies of scale arise whenever production costs comprise a sizeable fraction of fixed costs, that is, costs that are independent of the production scale. Production costs consist of two components: fixed costs (FC) and variable costs (VC). The first component does not vary with production (or at least it does not vary within a certain interval of production), whereas the second does increase with each additional unit of production. Assuming that variable costs increase proportionally (that is, linearly) with output, we can provide in figure 1 a simple graphical representation of the two components.

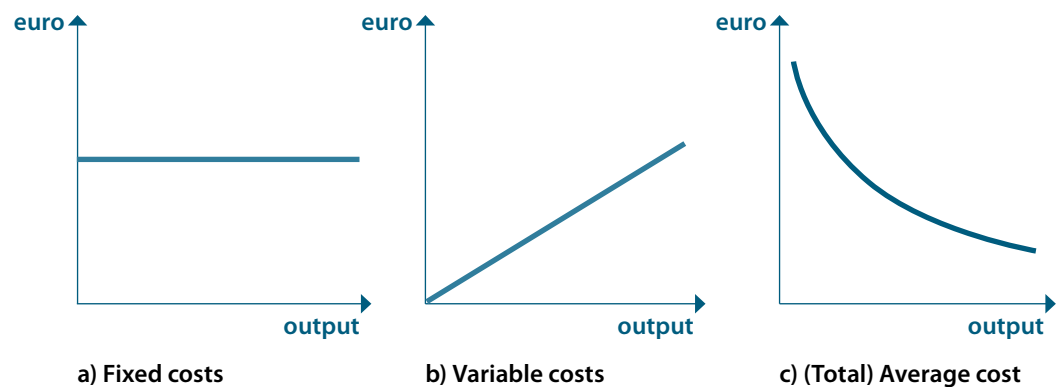


Figure 1: Production Costs

Since fixed costs are non-sensitive to output, they can be represented by means of a horizontal line; variable costs vary proportionally with output, and therefore the graphical representation of output is a straight line with a positive slope. Figure 1.c) also provides the graph of total average cost (TAC), which is given by the ratio $(FC+VC)/\text{output}$. TAC is an average measure of cost for each unit of output. Its non-linear shape depends on the presence of positive fixed costs. When output is low, fixed costs have to be spread over a few units, whereas when production is high, the same fixed costs apply to many more units, thus explaining TAC's shape, which decreases with the level of output.

In order to better understand the role of TAC in procurement contracts, consider the following example:

Example 1. Economies of scale in a procurement contract for delivering heating oil

A procurement contract requires the delivery of 10,000 litres of heating oil to a school. This is accomplished by using a tank truck with a capacity of 20,000 litres. From the economic operator's viewpoint, delivery costs (truck driver's salary, insurance, gasoline, etc.) are fixed costs up to 20,000 litres. If more oil were to be delivered, a second tank truck would be necessary. If the economic operator could serve two (possibly neighbouring) schools, each demanding 10,000 litres, then fixed costs would be spread over a twice as large output, thus implying a lower total average cost, that is, higher economies of scale.

2.2.2 Economies of scale, participation and competition

The dimension of product standardisation is sometimes hard to disentangle from demand heterogeneity. To see this dimension, consider a very simple case of procurement of gasoline. Gasoline might be considered to be a highly standardised commodity, but contracting authorities might have different preferences concerning delivery conditions and payment delays (this is referred to as 'demand heterogeneity'), with the result that procurement contracts would end up being different and unit costs could be pushed up.

Commodity standardisation should also be coupled with a low degree of demand heterogeneity so that aggregation can deploy its full potential. When this is the case, demand aggregation generally allows firms to produce at a lower unit cost.

Lower production costs yield lower purchasing prices *only* if the contracting authority keeps or increases its bargaining power, that is, provided that the degree of competition is (at least to some extent) positively correlated with the value of procurement contracts. Two conflicting forces come into play. Demand aggregation can lead to fiercer competition between economic operators. However, as the size of contracts becomes larger and larger, smaller economic operators may find it impossible to participate in the competitive processes – because of more demanding economic and financial requirements – and this entails a lower number of competitors. This last point can be illustrated by the following example:

Example 2. Demand aggregation, participation and competition

Procurement contract 1: EUR 150 000		Procurement contract 2: EUR 200 000	
Participating economic operators	Yearly turnover	Participating economic operators	Yearly turnover
A	EUR 1 000 000	A	EUR 1 000 000
B	EUR 500 000	B	EUR 500 000
C	EUR 200 000	D	EUR 300 000
		E	EUR 250 000

Consider two separate procurement processes for the same goods/services designed by two contracting authorities located in different regions. Suppose that one of the minimum requirements for selection to participate is that the economic operator's yearly turnover has to be greater than or equal to the value of the procurement contract. The following participation pattern has been observed: A and B competed for both contracts 1 and 2, whereas C competed only for contract 1, and D and E only for contract 2. If the two contracts had been merged into one EUR 350 000 contract, then C, D and E would have not been able to participate at all.

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In public procurement, centralisation can also save significant duplication costs, such as publication costs for advertisements (where charges are made), administrative costs, and litigation costs or costs associated with legal challenges. The likelihood, and thus the cost, of legal challenges may decrease with centralisation because:

- qualified resources involved in centralised procurement should improve the clarity, transparency and measurability of the formal requirements, i.e. the overall 'quality' of tender documents;
- centralisation reduces the number of procurement contracts for any item involved;
- it may be the case, depending on the venues in which procurement processes can be challenged under national legislation, that centralisation concentrates the challenges/litigation in a single court, while decentralisation may involve the courts, commissions or tribunals of each local administrative area.

2.2.3 **Specialisation and knowledge/information-sharing**

Generally the higher the level of centralisation, the more information/knowledge/data can be shared among procurement specialists. Large organisations are usually characterised by a high degree of specialisation in terms of human capital while, at the same time, producing a large volume of information. Knowledge-sharing is recognised to be a key (positive) externality arising within the boundaries of such organisations. In general, information-sharing improves efficiency through the use of more up-to-date data/information, problem-sharing and common solutions.

2.3 **FAVOURITISM**

Location-specific information – such as information regarding cleaning services, asset management, and road cadastre – may favour more decentralised procurement processes, as local information is likely to be relevant in setting quality standards and local delivery requirements that are not easily retrievable from official documents.

While the relevance of local information may favour decentralised procurement, it may also give rise to local favouritism, especially towards local economic operators, which may well be in breach of the EU *acquis*. Decentralised decisions have the potential of bringing local economic operators and local procurement officials into a closer, potentially long-lasting relationship, and the possibility of local lobbying activity influencing local procurement decisions may have a seriously negative impact on the efficiency of the whole process.

Favouritism may also take place at central level. However, the higher visibility of centralised procurement makes 'tailored' procurement strategies more difficult to implement. This last argument seems to be consistent with the results of international studies, such as the survey summarised in the comment box below.

Comment: Corruption in the Public Sector

According to the results of its 2005 worldwide survey on corruption entitled “Resisting Corruption in the Public Sector”, the International Consortium on Government Financial Management (ICGMF) recommended several actions to reduce corruption, including the action “[to] cure corruption-prone procurement by centralizing purchases”. The ICGMF suggested, whenever possible, to centralise acquisitions in order to reduce the opportunity for extra-tender negotiations or other forms of corruption, and to use electronic purchases, which reduce the discretion of processes and limit personal interactions.

2.4 **STRATEGIC PROCUREMENT**

Procurement is ‘strategic’ when it involves items/activities that have a considerable impact on business or national socio-economic policies. The higher the importance of those activities, the more centralised decisions tend to be since each purchasing decision is likely to exert a huge impact on the entire organisation. Governments usually consider the following areas as strategic activities:

- Defence
- Public health
- Environment

2.4.1 **Defence procurement**

Defence provides an example of foremost importance. Thus *defence procurement* is typically considered a strategic activity that requires centralised strategies, which is also due to the sensitivity of much of the information concerning such procurement. In the United States, defence procurement appears to be partially centralised in the hands of the Department of Defence (DoD), although the DoD allows for some degree of decentralisation. China has also progressively adopted a more centralised approach to defence procurement.

Example 3. Defence Procurement in the United States and in China

United States:

The [Defence Acquisition Guidebook](#) establishes that the Defence Acquisition System is the: “management process by which the Department acquires weapon systems and automated information systems. Although the system is based on centralized policies and principles, it allows for decentralized and streamlined execution of acquisition activities. This approach provides flexibility and encourages innovation, while maintaining strict emphasis on discipline and accountability”.

China:

In December 2004, the State Council Information Office published a white paper entitled [China’s National Defence in 2004](#). The document describes China’s national defence policies and the army’s modernisation process, including procurement approaches.

See module A5 for further information on procurement in the defence sector.

2.4.2 Public health

Public health stands as another strategic sector that would suggest the use of centralised procurement strategies for certain types of purchasing. For example, the requirement of co-ordinated actions and the enforcement of uniform minimum quality standards may favour a centralised approach to the procurement of drugs.

2.4.3 Environmental considerations and public procurement

Broadly speaking, *green procurement* policies aim to procure products and services that are more environment-friendly. Governments and international organisations alike are assuming increased responsibility to take into account the environmental impacts of their activities.

Centralised *green procurement* strategies may occur at a regulatory stage whenever minimal quality standards of environmental friendliness, which are compatible with the EU *acquis*, are imposed at a national or supranational level. In other circumstances, contracting authorities may be left free for example, within the context of the limits set by the *acquis*, to reward appropriately green dimensions characterising an economic operator's technical proposal. See module C5 for further information on environmental and social considerations in procurement.

Besides regulatory strategies, centralised procurement might be an important channel for promoting environment-sustainable policies and for establishing common standards. By imposing minimal (environment-friendly) quality standards and/or by rewarding green dimensions in the technical proposal, a contracting authority is compensating an economic operator for the positive externality that will be generated (for example, lower CO₂ emissions). Since positive externality affects a large community – possibly much larger than the one concerned by the current acquisition – the contracting authority's willingness to pay is likely to be greater the higher the degree of centralisation. Following this line of reasoning, only a fully centralised procurement system would be able to correctly reward the positive externalities generated by green policies.

2.5 NETWORKS AND STANDARDS

Network industries are predominant in modern economies. Key network industries are telecommunications, Internet services, computer software, some aspect of modern banking (ATM networks), and e-markets such as B2B, B2C and B2G platforms.

Note: Network effects

Goods or services are said to display *network effects* if their value to any user increases with the number of users already using them (a.k.a. *the installed base*). Take, for instance, the simple case of PCs' operating systems or software: using the same system, people can exchange many different types of files and easily process other users' documents. In other words, people in the same network 'speak the same language'. An even older example is the telephone. If only one person owned a telephone, its value would be nil.

When the number of users of a certain product with network effects is large enough, that product may *de facto* become a standard. A potentially serious problem may arise when another standard is available, but consumers, although inclined to consider the latter technologically superior to the former, are unwilling to switch because they are afraid that most of the other users will not follow ('users' lack of co-ordination'). Considerable care has to be exercised in these circumstances to ensure that specifications are not discriminatory and that economic operators are given equal opportunity and equal treatment.

A similar phenomenon may concern the government's purchases. When purchasing decisions are decentralised, switching to potentially superior technologies may become difficult if not impossible. Thus centralisation turns out to be a solution to the problem of the lack of co-ordination. In this spirit one might interpret the joint decision taken by the Brazilian Government and IBM in September 2004 to expand LINUX as an alternative to Microsoft Windows. This strategy was meant to fix common standards for the public sector but also to challenge Microsoft's dominant position in the relevant market.

2.6 EMERGENCIES

An emergency is usually considered as an *urgent need for goods or services*, due to facility failure in large areas or extensive damages caused by natural catastrophes. There are several reasons for favouring a centralised rather than a decentralised approach to procurement in the case of genuine emergencies:

- need for co-ordinated interventions;
- reduced risk of providing essential goods/services of different quality;
- reduced risk of corruption when additional funds are handled.

Example 5. Emergencies procurement in Afghanistan

An instructive example of emergencies procurement is the [Afghanistan Reconstruction and Development Services](#) (ARDS), created in May 2002 by the Transitional Islamic State of Afghanistan (TISA) in order to *cope up with the urgent task of reconstruction*. The ARDS appointed a consultant as the country's central Procurement Consultant (PC) to put in place emergency procurement capacity. Among the main objectives of the Procurement Consultant's assignment were:

- to facilitate rapid and transparent utilisation of donor resources for reconstruction and development;
- to improve efficiency in the procurement of the relevant goods, services and works;
- to disseminate the same information to all eligible economic operators in countries throughout the world and to offer to them an equal opportunity to compete;
- to encourage the development of domestic contracting and manufacturing industries in the borrowing country.

See module C4 for information on the conditions where an emergency situation may constitute an exceptional circumstance permitting the award of a contract without prior publication of a contract notice.

2.7 CENTRALISATION AND E-PROCUREMENT

The term e-procurement (electronic procurement) is often associated with e-auctions, which occur as the final tendering phase of the procurement process, although the coverage of e-procurement is in principle much wider, ranging from e-notices to e-invoicing and e-payment, not to mention e-catalogues.

Comment: The European Commission on e-procurement

The relevance of e-procurement is emphasised by the following statement by the European Commission:

“Modernising and opening up procurement markets across borders – including through the expansion of electronic procurement – is crucial to Europe’s competitiveness and for creating new opportunities for EU businesses. Using information technology appropriately can contribute to reducing costs, improving efficiency and removing barriers to trade, which will ultimately result in savings for taxpayers. The Directives adopted in March 2004 as part of the public procurement legislative package provide a legal framework aimed at boosting the development and use of electronic procurement.”

While the technological aspects of information technology (IT)-based procurement processes are endlessly debated, far less attention is paid to the impact on the organisational aspects and, more relevant to the current discussion, on the degree of centralisation of public procurement.

Even if e-procurement were limited to the final tendering stage of the process by using an e-auction, it could be argued that an electronic procedure might be less expensive than a paper-based procedure. Consequently, e-procurement solutions should make centralised procurement less convenient, as each isolated contracting authority would spend fewer resources by setting up its own e-tendering procedure. However, such an argument overlooks the technological choice that underlies a simple e-auction. In other words, there is no unique *technological standard* for running e-auctions. Therefore the more independently local purchasing units behave, the more likely that technological choices will turn out to be not entirely compatible, thus raising firms’ costs in becoming acquainted with different standards.

Because it relies on a single standard, a centralised procurement strategy would reduce such costs, thereby fostering, all other factors being equal, the participation of smaller firms in the procurement market. Furthermore, *centralisation is likely to magnify the benefits of e-procurement*. Internet-based sourcing magnifies efficiency gains if procurement becomes more centralised since such gains would affect larger volumes of transactions and would impact on a greater number of organisational structures.

See below section C of this module A4 for further discussion of the economic issues affecting the choice of using e-auctions and also module C4 for rules applying to the use of e-auctions.

SECTION 2B PROCUREMENT CONTRACTING STRATEGIES

Localisation: This section may require considerable amendment if, for example, local laws set out the form of contract that contracting authorities are obliged to use. Under those circumstances, consider retaining this section for general information and include a warning that sets out the local legal situation.

1

OVERVIEW

In this section we will look at the main types of procurement contracts used by contracting authorities and how the nature of the economic operator's tasks and the degree of predictability of events affecting the economic operator's performance determine the contracting authority's choice of contract. We also consider how to design a contract so as to encourage the economic operator to take those actions that are most likely to satisfy the contracting authority's requirements. At the end of this section we look at some examples of objective and subjective performance measures.

2.1

CHOICE OF PROCUREMENT CONTRACT

There are three broad categories of procurement contracts from an economic perspective: cost reimbursement (or cost-plus), fixed price, and incentive contracts. Many procurement contracts are in fact a combination of the three broad categories, specifying incentives for some aspects and fixed-price for others, and combining contract types in order to adapt the contract to the specific circumstances faced by the contracting authority.

■ Cost-reimbursement contracts

The distinguishing feature of cost-reimbursement contracts (CRCs) is that the contracting authority agrees to reimburse all (documented) production costs related to the project and may also agreed to pay a fee for supervision (also defined as a cost-plus-fixed-fee contract, according to the Federal Acquisition Regulation in the United States). While fully ensuring against cost overruns, CRCs do not provide the economic operator with any incentive to undertake cost reduction.

Comment

A capped-price contract (CPC) is a special form of CRC in that a daily fee, which also includes a profit component, is agreed for a certain capped (limited) number of days. The cap is clearly indicated in the contract/purchase order. If the economic operator is able to complete the task in less than the stipulated number of days, then its bill will be lower than the capped amount. If, however, the economic operator needs additional days to complete the task, it either has to take a loss or make a case for increasing the cap, in accordance with pre-agreed contractual provisions, where permissible, under the EU *acquis* and national legal provisions.

Unit-price contracts (UPCs) are similar to CPCs in that the contracting authority asks economic operators to submit offers specifying a separate unit price for each input factor, but UPCs do not include any cap. Moreover, the contracting authority announces an estimate of the quantity of the input factors needed to complete the project. For each incoming offer, the contracting authority evaluates the overall expected cost, or the 'score' of this offer. The contracting authority awards the contract to the firm with the lowest score (cost), but is obliged to pay for the input factor needed to complete the project. This approach may be more appropriate for a mini-competition run in the context of a framework arrangement.

- **Fixed-price contracts**

A fixed-price contract (FPC) is a contractual agreement whereby the economic operator is paid a fixed price for realising a project that satisfies a predetermined quality standard. While the economic operator receives no additional payment for achieving higher quality standards, penalties are typically included in the contract so as to protect the contracting authority from the risk of having the economic operator opportunistically deliver lower-quality standards than those laid down in the contract. An FPC does not generally provide any 'insurance' for the economic operator against cost overruns, but at the same time the economic operator enjoys the benefit of possible cost savings while fulfilling quality standards as agreed.

The category of fixed-price contracts also comprises some variants. One example is the fixed-price contract with economic price adjustment (FPCPA), which takes into account fluctuations of input costs (labour and material) incurred by the economic operator. The logic behind such a contract is to reduce the risk of large and, possibly unexpected, fluctuations in input prices, which normally leave the economic operator with no other option but to save money by reducing quality standards if renegotiation is too costly.

■ Incentive contracts

Incentive contracts (ICs) may be considered as a compromise between the two extremes of CRCs and FPCs. ICs typically include a target cost, a target profit, and a profit adjustment formula, which ensures that (i) actual cost or quality that meets the target will result in the target profit or fee; (ii) actual cost that exceeds the target will result in a downward adjustment of the target profit or fee; and (iii) actual cost or quality that is below the target will result in an upward adjustment of the target profit or fee. In the next part of this section we will look at how two main alternative contractual solutions, Cost-Reimbursement Contracts (CRCs) and Fixed-Price Contracts (FPCs), work in a given scenario. Each contract solution generates different behaviour on the economic operator's side in particular and may consequently have a different impact in terms of perceived or actual levels of quality and overall costs. We will illustrate the fundamental line of reasoning by analysing the following scenario.

Example 1. From the procurement of heating oil to the procurement of heating services

Consider a municipality facing the problem of heating local schools. Procurement officials have been tackling the problem for quite some time in a seemingly intuitive fashion: they select an economic operator to supply oil for heating according to the schools' needs. For instance, high-consumption patterns would be observed from December to February, while demand would drop in October and March. The economic operator is paid according to the amount of fuel that is supplied. This is commonly known as a cost-reimbursement contract (CRC).

More recently, a different approach called 'energy services' has been advocated. The basic idea is to select an economic operator that would take all necessary measures in order to keep the temperature inside school buildings at an agreed level, say 19°C, from 8 a.m. until 5 p.m. The economic operator is paid an agreed, fixed fee for the entire service, which includes the cost of fuel, irrespective of how much fuel is actually used. Such a contractual agreement is known as a fixed-price contract (FPC).

We will now look at the two contracting strategies and consider the key issue of the allocation of procurement risk between the contracting parties (the contracting authority and the economic operator).

2.1.1. Procurement risk

Referring to the example above, suppose that the contracting authority wishes to keep the temperature in the school buildings at 19°C, whichever the kind of contract. By using a cost-reimbursement contract (CRC), the economic operator would be reimbursed for all documented costs necessary to achieve the agreed performance. The economic operator would be paid for the heating oil that it supplied and so it would not be concerned, for example, about the frequency of winter storms or broken glass in the windows, as neither of these factors would affect the payment that the economic operator would receive. In this case the risk would be fully borne by the contracting authority, and the economic operator would be unconcerned and unaffected by external events or issues, such as the quality and maintenance of the school buildings.

The choice of a fixed-price contract (FPC) shifts almost all risks to the economic operator. The economic operator now has a strong interest in undertaking all possible actions to reduce the impact of cost-increase factors. For instance, it makes sure that the glass in the windows is not broken and evaluates loft insulation. Since in an uninsulated building up to one quarter of the heat is lost through the roof, proper insulation would help use fuel oil more efficiently (thus reducing CO₂ emissions), and the economic operator might therefore decide to install more insulation in order to reduce the amount of oil consumed and to reduce the economic risks associated with volatile fuel prices. While paying a fixed price for the contract, the contracting authority also knows that the contractor will invest resources in building maintenance, thus ‘killing two birds with one stone’.

A more in-depth discussion of the concept of procurement risk is provided in the box below.

Note: The nature of economic agents’ attitude towards risk

Procurement risk refers to those events that may affect the realisation of the contractual performance, and occurrence of which cannot be accurately *predicted* and *influenced* by contracting parties. By affecting *actual* production costs, it has an impact on the actual quality of the performance. Most importantly, the buyer and the economic operator care about ‘extreme’ events, such as the risk of default by the economic operator, which might disrupt the service altogether. The degree of fear of (procurement) risk, is also called *risk aversion*.

The concept of risk aversion can be clarified by the following example. Suppose that a firm has to choose between two possible investment decisions, A and B. Option A guarantees a yield of EUR 100, option B yields zero 50% of the time and EUR 200 the other 50% of the time. A firm is said to have a fear of risk (or to be risk-averse) if it prefers option A to option B, that is, if it prefers a risk-free investment with a (guaranteed) monetary value that is exactly equal to the expected monetary value of the risky investment, where the latter is a weighted average of the risky outcomes, with weights provided by the probability that each outcome occurs ($1/2 \cdot \text{EUR } 0 + 1/2 \cdot \text{EUR } 200 = \text{EUR } 100$). Indifference to risk (or risk neutrality), on the other hand, describes a firm that has no particular interest in either option A or option B. In other words, the firm is indifferent to whether the investment is a sure bet or a risky bet that has an expected monetary value equal to that of the sure bet.

In procurement contracts, it is unlikely that an economic operator is able to immunise itself (for example, through an insurance contract) against all unpredictable events. However, the breadth and nature of an economic operator’s activities may provide useful *proxies* for its ability to ‘insure’ itself against the vagaries of a specific procurement contract. Possible internal ‘insurance policies’ are thus provided by the value of the contract being only a tiny fraction of the economic operator’s turnover, a high degree of diversification of the economic operator’s activities, and, more generally, by the economic operator’s ease of access to the credit market.

The absolute capacity of each contracting party to bear the procurement risk is not, however, the most relevant factor in the selection of the contractual form. What really matters is the contracting parties’ *relative* attitude toward risk: other factors being equal, efficient risk-sharing calls for the allocation of risk to the party that is able to manage it best.

2.1.3. **Fixed price or cost reimbursement?**

So far the discussion has focused on a specific set of circumstances where contracting authorities may find it to be both value-for-money and a commercial opportunity to shift the brunt of procurement risk to economic operators.

The following general guidelines point to where each of the two different types of contracts may be more appropriate than the other:

Cost-reimbursement contracts may be favoured in the following circumstances, where:

- it is a highly complex project;
- there are unforeseen contingencies, that is, events out of control of contracting parties that may lead to serious project disruptions;
- there is a need for contract flexibility;
- the relevance of quality dimensions are difficult to measure (e.g. proactiveness of a management consultant, user-friendliness of computer software).

Fixed-price contracts may be favoured where:

- the contracting authority wishes to buy goods/services satisfying only a minimum level of technical specifications;
- the economic operator has full control over most of the events affecting production costs;
- the economic operator's needs remain unchanged throughout the execution of the contract.

Before concluding this section, it is worth emphasising that in many real-world procurement processes various kinds of contracts or various elements of both types of contracts may be combined, such as the example in section 2.2 below.

2.2. HOW TO DEAL WITH HETEROGENEOUS TASKS IN THE SAME CONTRACT

Contracting authorities sometimes procure complex projects, where the complexity stems from tasks with performance measures that either may be of varying precision or may become available at different points in time due to, for example, the contracting authority's evolving needs. The example below will briefly illustrate a situation in which the latter scenario arises.

Example 2. Procurement of IT consultancy services

It is customary that IT consultancy procurement contracts (for e-government projects, for example) require the realisation of quite heterogeneous tasks, such as:

- process re-engineering;
- software maintenance and development;
- data warehouse, database management, and data monitoring;
- management of websites (development, publishing, etc.);
- help-desk and end-user assistance and support;
- corporate assistance and support.

As regards software development, there exists a common standard in the IT service market that measures software complexity, namely the *function point*. In addition to measuring output, function point analysis is useful when measuring consultant teams' productivity and when communicating functional requirements.

Other on-demand types of tasks become projects of their own, which have to be realised by a team of consultants with varying skills/seniority.

The example above highlights the presence of two quite heterogeneous sets of tasks: one concerns software development, which is characterised by a measure of output/performance; the other is more input-oriented (the composition of the team of consultants) due to the fact that the tasks are only loosely specified and the contracting authority's needs may change as the project develops.

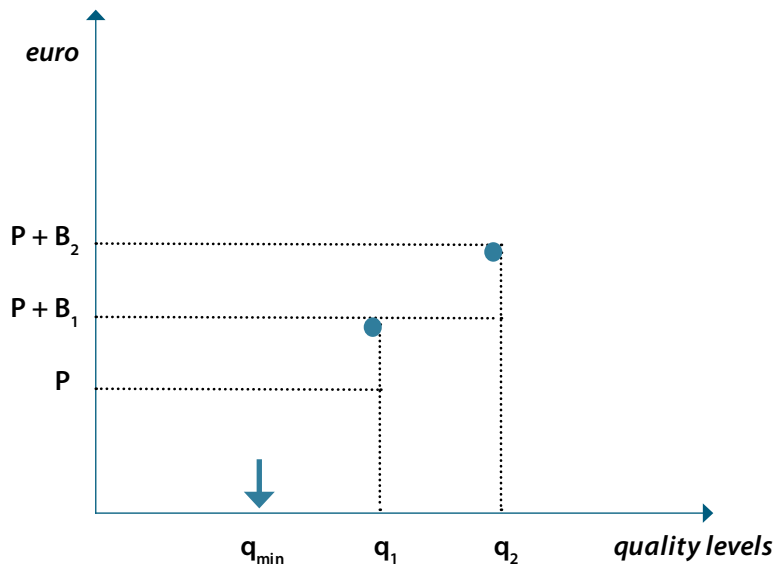
In those circumstances, the contracting authority should consider awarding a contract that has more than one payment method: a number of requirements would be paid by means of a fixed amount (fixed-price component), while on-demand projects could be paid by using a capped-price component. The latter is a kind of cost-reimbursement reward scheme whereby a set fee per day (to be applied to the whole team) for a maximum number of days (i.e. the longest estimated duration of the project).

2.3. **INCENTIVE CONTRACTS: QUALITY-INCENTIVE CONTRACTS**

Incentive contracts are within the spectrum between cost-reimbursement and fixed-price contracts in that the contractor receives a two-part reward scheme: a fixed component and a variable component, where the latter depends upon performance-enhancing targets. While referring to section 2.3.1 below and the Additional Note on cost-incentive contracts, which are mainly used in public works or in the procurement of high-tech products, we focus here on quality-incentive contracts, which are more commonly used for the procurement of off-the-shelf goods and services.

Quality-incentive contracts normally set a baseline quality level and an improvement schedule, specifying how much the contracting authority buyer is willing to pay for quality targets that are higher than the baseline level. In this case, an incentive contract normally specifies a base payment **P** for minimum performance q_{min} , typically a quality measure, and additional higher target levels q_1, \dots, q_n with corresponding bonuses B_1, \dots, B_n . Figure 1 below illustrates a simple quality incentive scheme with two quality levels higher than the minimum performance.

Figure 1: A quality incentive scheme



There are two main categories of incentive schemes, depending on the extent to which contracting parties are able to define *objective performance measures*, that is, quality targets that are not only observable by themselves, but that can also be checked by third parties (e.g. courts of law). In the first category of quality-incentive schemes, we are dealing with *verifiable quality dimensions*.

Example 3. Some verifiable quality dimensions

- Time of delivery of a product
- Speed of problem-resolution in a help-desk service
- Level of faultiness of new software, which can be measured by the ratio between the number of failures during the testing phase and the software's complexity level (covered by the software's number of function points – see example 2 above)
- Network size of cafeterias that are willing to accept a specific restaurant voucher as a means of payment
- Number of gasoline stations owned by an oil company

Quality-incentive contracts are, in principle, a more sophisticated tool than fixed-price contracts in that the contracting authority buyer has to specify in advance how many quality targets, besides the baseline level, are to be rewarded and the value of bonuses. Consequently, management costs are likely to be higher than for fixed-price contracts. On the other hand, the contracting authority buyer offers the economic operator some degree of 'upward flexibility' in quality performance, thus providing a very efficient economic operator with an incentive to pursue higher rewards by increasing quality levels, provided that the economic operator's marginal benefit in delivering higher quality (the bonus scheme) more than compensates for additional production costs. These arguments will be further developed in the following example.

Example 4. Quality-incentive schedule for software maintenance

When contracting authorities plan to purchase sophisticated software (such as those used for running a state budget or managing public debt), maintenance clauses are among the most sensitive dimensions of the procurement contract. A standard contract would in principle specify a maximum delay (say, three hours) for restoring the software after any breakdown occurs. A baseline payment (EUR 1 000) is established accordingly. The contracting authority can also determine additional delay thresholds and corresponding bonuses. For instance, a bonus of EUR 100 if recovery occurs within two hours, and EUR 200 if recovery occurs within one hour.

When the quality-improvement schedule is fixed, the contracting authority is always unsure as to whether the selected economic operator will find it profitable to go beyond the baseline quality level. For this reason, the contracting authority may find it in its interest to let economic operators submit offers for both the fixed and the variable parts of the contract. Why? If economic operators can bid on both the fixed and the variable parts, very efficient economic operators will 'signal' their nature by submitting a relatively low fixed component and a relatively high variable component, as they have a comparative advantage (compared to less efficient economic operators) in achieving a higher level of performance. In terms of Figure 1 above, given the levels of q_{\min} , q_1 and q_2 , which are determined by procurement officials, efficient economic operators will submit a low P and high B_1 and B_2 .

Warning!

All activities related to the management of an incentive contract constitute transaction costs. Sizeable transaction costs may undermine the feasibility of incentive contracts. If the expected benefits of adopting an incentive contract are outweighed by the value of transaction costs, the contracting authority may find it in its interest to adopt a fixed-price contract that is easier to write and less costly to manage. While the fixed-price contract shifts completely the procurement risk to the economic operator's side, it allows the procurer (the contracting authority) to minimise costs in information collection.

2.3.1. **Incentive schemes with non-verifiable quality dimensions**

Procurement contracts often require the economic operator to invest resources in quality dimensions that cannot be explicitly described by contractual clauses, even if they can be observed by both parties. We will refer to such quality dimensions as *non-verifiable quality*, as these dimensions cannot be verified by third parties. Examples would include the acquisition of IT or management consultancy services, where the quality of human capital is a multi-dimensional variable, but also procurement contracts for the development of new software. Some non-verifiable quality dimensions are listed below.

Example 5. Some non-verifiable quality dimensions

- A consultant's proactiveness
- A new software's degree of user-friendliness
- Kindness/courtesy of a help-desk operator

There are internationally accepted (statistical) tools to measure a user's perception of quality dimensions for a product or service that are *subjective* (i.e. non-verifiable by anyone else but the user) rather than *objective* (thus verifiable). One of the most widely used tool is the *Customer Satisfaction Index* (CSI). The final example of this section will briefly illustrate how a CSI can be used to construct an incentive scheme.

Example 6. A simple CSI-based incentive scheme for call-centre/help-desk services

Call-centre services are normally rewarded on a fixed-price basis. For instance, each phone call yields the economic operator EUR 6, provided that some objective quality measures are fulfilled (delays in answering the phone call, number of problems remaining unresolved, etc.). Yet much of the users' benefit from using the help-desk service is based on subjective dimensions that could be measured, at least in principle, by a specialised firm (outside of the procurement contract) through a customer satisfaction survey.

Consequently, procurement officials might design a contract in such a way that the contract award price P is split into two parts. The payment of the first part, αP , with α greater than 0% and lower than 100%, is conditional on the fulfilment of objective quality targets; the remaining part $(1-\alpha)P$ is paid only if a certain threshold of CSI is reached. For a two-year contract, the incentive schedule might look as follows:

Suppose that $P = \text{EUR } 6$ and that α is 90% (remember that P is the price per phone call!). Then,

Year 1: One-third of $0.1P$ (the fraction of the compensation linked to a subjective measure) is paid if CSI is above 70/100, but below 85/100; the remaining two-thirds of $0.1P$ is paid if CSI is greater than 85/100.

Year 2: One-third of $0.1P$ is paid if CSI is above 75/100, but below 90/100; the remaining two-thirds of $0.1P$ is paid if CSI is greater than 90/100.

Localisation: The extent to which a fraction of the contract can be linked to a subjective measure – that is, $(1-\alpha)P$ – is likely to vary from country to country, depending on various aspects, such as secondary legislation concerning public contracts and contractual practices.

Additional note on incentive contracts

Incentive contracts (ICs) often take the form of linear cost-incentive contracts. The most common form of cost-incentive contracts is linear and can be described by the following compensation scheme for the economic operator:

$$T = P + b(C - P)$$

where **T** is the total transfer to the economic operator, **P** is the target cost (or bid price), **C** is the realised (verifiable) cost, and **b** is the (positive) parameter representing the share of costs borne by the contracting authority. If $P > C$ then the contracting authority enjoys a fraction **b** of the cost savings. Instead, if $P < C$ the contracting authority pays for a fraction **(1-b)** of cost overrun.

The cost-sharing parameter **b** plays a crucial role in the economic operator's incentives to reduce cost. The higher **b**, the less the economic operator is responsible for cost overruns and the less the economic operator benefits from cost reduction, and therefore the higher the cost-sharing parameter **b**, the lower the incentive of the economic operator to reduce cost (that is, using economics terms, the lower 'power of the incentive scheme').

What criteria should the contracting authority adopt to set the cost-sharing parameter **b**? Three factors affect the choice of **b**: the ability of the economic operator to bear the procurement risk, the predictability (*i.e.* the variability) of events affecting production costs, and the responsiveness of the actual production cost to cost-reducing activities (*e.g.* investment, efforts).

In a procurement environment where both unpredictable events and the economic operator's actions/investments affect the level of actual production costs, but where neither of these factors is *the* crucial dimension, ICs can be a good choice for the contracting authority. ICs *(i)* motivate the economic operator to undertake cost-reducing actions, and *(ii)* offer the economic operator a form of 'insurance' against adverse exogenous events.

SECTION 2C

DESIGN OF THE COMPETITIVE TENDERING FORMAT: COMPETITION WITH SEALED-BIDS AND ELECTRONIC AUCTIONS

Localisation: This section may require amendments to reflect local requirements in relation to the use and conduct of e-auctions.

1 OVERVIEW

In this section we look at the elements that make up the costs of a contract and the mistakes that economic operators can make when estimating the cost of delivering a contract. We will see the impact of uncertainty on an economic operator's production costs and the role that uncertainty plays when a contracting authority is deciding whether or not to use an e-auction. We will also look briefly at the way in which a specific competitive approach affects the risk of collusion between economic operators.

2.1 PRIVATE AND COMMON DIMENSIONS IN THE COST FUNCTION

When estimating the cost of performing a contract, each economic operator has to consider at least two different dimensions. The first dimension concerns the economic operator's efficiency in performing each task specified in the contract. Efficiency results from the interaction between the experience of the economic operator's personnel in carrying out similar tasks and, more generally, the firm's managerial skills. Thus the economic operator's efficiency includes a *private* component in its production cost. It is *private* in that it is entirely firm-specific. The second dimension concerns the economic operator's ability to correctly estimate the mix of the various tasks specified in the contract. Such an uncertainty is *common* to all economic operators.

Uncertainty about the common component matters, as the economic operator may find out that the 'true' cost of performing the contract differs from its initial estimate. This may happen if the economic operator submitted a bid on the basis of an overly optimistic estimate of the common component. More generally, if an economic operator does not take this possibility into account at the time of bidding for the contract, it may suffer from the 'winner's curse', that is, it may realise that the actual production costs are higher than the estimated costs. On the one hand, the danger of running losses *ex post* may induce economic operators to bid too cautiously for the contract, which potentially implies high award prices for the contracting authority. On the other hand, the economic operator's inability to recognise the 'winner's curse' may generate overly aggressive bidding, which may result in lower prices for the contracting authority but may also induce the economic operator to cut production costs by lowering the quality of the performance.

One simple way of including both private and common dimensions in the economic operator's costs is by using the following general relationship:

$$\text{Cost} = C (\text{Private}, \text{Common})$$

The relationship makes it clear that, in general, both components affect production costs, although the design of a competitive procurement process sometimes requires the contracting authority to establish which dimension is the more relevant, as we will see in the following sections.

2.1.1 The private component

Example 1. Procurement of cleaning services

Consider a contract for cleaning services. The contract comprises two main space categories A) offices and corridors, and B) laboratories. Table 1 below summarises the estimated costs per square metre for PROPER Ltd ('PROPER'), one of the competing economic operators. The table also indicates the exact size of the surface areas to be cleaned for both categories A and B.

Thus we consider the simplest bidding environment, where each economic operator understands clearly the composition of the final demand for cleaning services. Hence PROPER's bid for the contract will depend only on its (private) efficiency component, although perhaps also on its conjectures concerning other competitors' efficiency levels. The cleaning contract for the two space categories will be awarded by means of a competitive tendering process, using lowest price as the award criterion and with a reserve price of EUR 70/m², so that any bid above this level will be rejected.

Table 1

	A	B
Reserve Price (EUR/square metre)	70	
Private Value Component Estimated cleaning costs: (EUR/square metre)	40	80
Common Value Component with no uncertainty Surface to be cleaned: (square metres)	30,000	10,000

PROPER's cost for performing the contract is simply a weighted average of the two unit costs, where the weights reflect the fraction of each category of space in the contract:

$$\text{Unit Cost} = (\text{EUR } 40 \times 30,000 + \text{EUR } 80 \times 10,000) / 40,000 = \text{EUR } 50/\text{m}^2$$

PROPER can safely submit prices between EUR 50 and EUR 70, without losing money. The exact bid will depend on its conjectures about other competitors' bids. For instance, if PROPER faces a group of rivals with large market shares and with an established reputation of high expertise in the business, then it may anticipate intense competition for the contract. This would probably induce PROPER to bid closer to EUR 50 than to EUR 70.

2.1.2 **The common component and the ‘winner’s curse’**

PROPER’s bidding strategy becomes more complex when uncertainty affects the common component of production costs. Table 2 below illustrates the situation in which the demands of both category A and category B of surface area are unknown to PROPER and to all other economic operators. Imprecise information about the composition of the final demand often arises when the contracting authority awards framework contracts or, more generally, when the awarding authority is acting on behalf of other contracting authorities. In this case, a contract may specify the minimum and maximum quantities that the participating contracting authorities can purchase. However, it is not known at the time of the competitive tendering whether contracting authorities – and which ones in particular – will make use of the contract under a framework agreement. In this case the precise mix of the various categories of surface areas to be cleaned may not be clear to the economic operators when they prepare their tenders.

Table 2

	A	B
Reserve Price (EUR/square metre)	70	
Private Value Component Estimated cleaning costs: (EUR/square metre)	40	80
True Demand for Cleaning Services Surface to be cleaned: (square metres)	30,000	10,000
Estimated Common Value Component Surface to be cleaned: (square metres)	32,000	2,000

Economic operators may gather information about both categories of surface areas by inspecting a sample of buildings. In fact, PROPER has inspected a sample of five buildings and recorded the surface areas occupied by offices, corridors and laboratories in each site. Table 3 below indicates the results of that inspection.

Table 3

First Building	Second Building	Third Building	Fourth Building	Fifth Building	Sample Average (SA)	Estimated Number of Buildings to be Cleaned (NB)	Estimated Surface Area (SA*NB)
1,000	2,200	1,600	500	2,700	1,600	20	32,000
80	120	100	140	60	100	20	2,000

Table 3 shows that PROPER observed a sample average of 1,600 m² of category A surface area; it also observed a sample average of 100 m² of category B surface area. Moreover, data concerning a previously awarded contract and other similar contracts induce PROPER to believe that the contract will cover 20 buildings. Multiplying the sample average by the estimated number of buildings to be cleaned, PROPER estimates a surface of 32,000 square metres for category A and 2,000 square metres for category B. If PROPER were to predict the unit cost by using only the sample observations, it would derive a unit cost equal to:

$$(40 \times 32,000 + 80 \times 2,000) / 34,000 = \text{EUR } 43.52 / (\text{square metre})$$

Sample observations lead PROPER to overestimate the task requiring the lower unit cost and to underestimate the task with the higher unit cost. As a result, submitting unit prices between EUR 43.52 and EUR 50 will result in PROPER losing money.

In practice, different economic operators may have different information concerning the composition of the demand, which is easily explained by different samples of inspected buildings, but also by the economic operators' past experience with similar contracts. PROPER, for instance, belongs to the group of economic operators that has almost no experience with similar contracts, while CLEANFAST Ltd ('CLEANFAST'), for example, has a long history of participation in procurement contracts for cleaning services and is able to reasonably predict the range of category A and category B surface areas to be cleaned.

If economic operators are similar in terms of intrinsic efficiency (due, say, to similar efficiency of their cleaning personnel), the contract is likely to be awarded to the firm with the most favourable information concerning the contract, that is, to the economic operator that most accurately underestimates the impact of the high-cost task and overestimates the impact of the low-cost task.

In general, some estimates of the 'true' cost for cleaning the different categories of surface areas will be higher, while others will be lower than the 'true' cost. Given the heuristic bidding strategy, the successful economic operator will be the one that had the most optimistic estimate of the 'true' cost. Hence, it is possible that the economic operator's winning bid (that is, its initial cost estimate plus a fixed mark-up) does not cover the 'true' cost of performing the contract.

To sum up, if an economic operator ignores the possibility of holding an overly optimistic view of the composition of the demand, it may end up suffering from the ‘winner’s curse’, i.e. being awarded the contract that will eventually generate losses.

From the contracting authority’s point of view, the ‘winner’s curse’ may generate two kinds of problems: underbidding and overbidding.

- *Underbidding*: If an economic operator is aware of the ‘winner’s curse’ and is afraid of suffering losses, it may adopt an overly cautious bidding strategy, which in turn will generate high prices.
- *Overbidding*: If an economic operator is unaware of the ‘winner’s curse’, it prepares its bidding strategy on the basis of its cost estimate only. It may therefore end up bidding too aggressively, thus submitting prices that are too low. Although this might benefit the contracting authority in terms of low award prices, it might also deteriorate the economic operator’s financial stability and induce it to adopt opportunistic cost-reducing actions that would result in a poor quality of service. Even worse, the economic operator might go bankrupt and fail to deliver the contract altogether.

2.3. COSTS AND BENEFITS OF INFORMATION CIRCULATION: CHOOSING THE COMPETITIVE TENDERING FORMAT

The previous section described a competitive environment in which two competitors, PROPER and CLEANFAST, relied on considerably different experiences when preparing their tenders. In addition, the simple fact that PROPER considered CLEANFAST as an ‘expert’ in the market may have induced the former to believe that any positive information that it had received about the current contract (with a low estimated unit cost) made it more likely that CLEANFAST had received positive information as well.

This situation covers a broad set of circumstances in which the contracting authority would benefit from using an e-auction rather than a competitive, sealed-bid tendering format without an e-auction. The latter would certainly leave inexperienced and poorly informed economic operators (like PROPER) fully exposed to the risk of overbidding. Why? The simple, almost obvious, reason is that such a bidder would have to rely on its very limited information and experience to make a fairly complicated assessment of the ‘true’ demand for the cleaning service.

Information production during an e-auction process helps economic operators revise their estimates of the common component. In doing so, they may avoid becoming victims of underbidding when adjusting for the ‘winner’s curse’ or of overbidding when relying only on their estimates of the common component (this was the case of PROPER). In an e-auction more confident economic operators bid more aggressively than in competitive processes with sealed-bid formats, thus benefiting the contracting authority through a lower price. Moreover, the winning economic operator discovers more frequently *ex post* that the cost of serving the contract is no higher than its *ex ante* estimate. It is therefore less likely that the economic operator will look for opportunistic, cost-reducing actions that would undermine the quality of the service.

There are two sources of concern for a contracting authority when opting for an e-auction:

1. Information circulation may increase the risk of collusion, especially in e-auctions for multiple contracts. Indeed, economic operators can exploit the openness of the e-auction format to send signals to each other (through prices) in order to co-ordinate their bids. Moreover, e-auctions may enable members of a bidding ring to detect deviation from a collusive scheme and to punish deviating economic operators.
2. The transparency and openness of an e-auction format may induce some economic operators to adopt bidding strategies in order (i) to conceal their information from rivals or, to the other extreme, (ii) to bluff, i.e. deceive, rivals.

The kind of strategies in 2. (i) above, sometimes described as acting like a ‘snake in the grass’, are more likely to take place in those e-auction formats in which the pace at which prices evolve over time depends entirely upon bidders’ activity. A slow-moving bidding process may produce little valuable information and may result in an excessively long auction. Strategies in 2. (ii) above may take the form of ‘jump bidding’, namely bidding behaviour whereby an economic operator submits a very aggressive – that is, low – price early in the contest, which is meant to ‘persuade’ competitors that it is in a position to be awarded the contract at a very low price, thus deterring further competition.

Does an e-auction format automatically solve the problems of underbidding and overbidding? Unfortunately, there are other aspects of information circulation during the auction that are likely to affect the learning process for economic operators and, consequently, the extent to which underbidding or overbidding occurs, as the following example illustrates.

Example 2. e-auction with a fixed-end rule

A fixed-end rule means that procurement officials publicly announce a deadline for the bidding process. This deadline can be expressed in terms of a predetermined number of rounds or a fixed time period (e.g. three hours since the starting time). If economic operators are allowed to raise discounts (or lower prices) by small amounts (‘ticks’), they may opt for a ‘snake-in-the-grass’ strategy. Experienced economic operators may have a special interest in doing so as not to disclose their information to less experienced or poorly informed economic operators. Bidding activity may therefore become more lively only in the last few minutes (or in the final round), thus leaving little time (or no time at all) for inexperienced economic operators to learn about the common component. However, if the end of the e-auction can be extended, the outcome might change substantially. Such a simple modification of the design might considerably affect the evolution of the bidding process and, consequently, the amount of information circulation during the auction.

Whenever the contracting authority is concerned with information production, it can take other actions that may be at least as effective as the appropriate choice of rules for an e-auction. In an effort to mitigate uncertainty, the contracting authority should include in the contract, and more generally in the e-auction design, as many important aspects related to the market as possible. Together with the duration of the contract, the contracting authority can specify the geographical areas where the contract applies, maximum and/or minimum quantities to be supplied, and any other aspects that may help bidders to properly evaluate the cost of the contract.

Guidelines on the tendering format

- Consider a sealed-bid tendering without an e-auction when economic operators' cost functions are mainly driven by private-value components or when competing economic operators have access to similar information about common-value components.
- When opting for an e-auction, **avoid:**
 - fixing exogenously the number of rounds, unless mechanisms for forcing bids downwards are put in place;
 - leaving economic operators in a position to determine price dynamics.

SECTION 2D SPLITTING CONTRACTS INTO LOTS

1 OVERVIEW

In this section we will look at the economic factors that contracting authorities should take into account when deciding whether or not to split contracts into lots. We will look at the consequences of that decision on the procurement process and on the degree of competition. We will also consider how to split contracts into lots while minimising the risk of collusion between economic operators.

2.1 INTRODUCTION

One of the main choices in public procurement is the decision as to whether works, goods or services should be bought by means of one contract or a number of separate contracts. The decision is not an easy one. On the one hand, large corporations and centralised public procurement agencies often find it profitable to divide contracts into smaller – often geographical – lots when economic operators are dispersed over the relevant territory. On the other hand, the presence of fixed costs in realising the procurement contract gives rise to potentially sizeable economies of scale, thus leading to the decision to use a single contract.

Division into lots has two key consequences in terms of levels of participation in the competitive tendering process and of the degree of competition.

- First, the size of each lot determines which potential economic operators possess the economic requirements to participate in each separate competitive tendering. As it affects participation, the division into lots therefore has a huge impact on economic operators' behaviour and on the final outcome of the tendering process.
- Second, the division into lots determines how a procurement contract can be 'split' between potential competitors and it therefore makes it easy for bidders to achieve and sustain implicit or explicit collusive agreements so as to share the supply at inflated prices.

2.2 DIVISION INTO LOTS AND REVENUE/EFFICIENCY CONSIDERATIONS

In this section we will take the number of economic operators as fixed and assume that these operators do not collude, i.e. they bid for the contract without attempting to co-ordinate their strategies. We will focus on the case where each lot is awarded using the lowest-price criterion. In order to correctly address the question of optimal division into lots, we have to make an assumption about the contracting authority's objective(s): its objective might be to either minimise procurement costs or achieve an efficient allocation of lots (i.e. to award the lots to the most efficient economic operators) or some combination of both. Sometimes those two objectives coincide, while in some other cases a conflict between the two arises. We will explicitly mention whenever the latter is the case.

When deciding on the number and configuration of items, the contracting authority should consider the following factors:

- Relevance of economies of scale
- Number of potential participants and their degree of specialisation in production
- After-market trade (subcontracting)

The importance of each of the above factors will be illustrated by means of the following scenarios.

Example 1. Procurement contract for office refurbishment

Consider the procurement of the manufacturing and installation of furniture for two neighbouring office buildings. A firm that furnishes both buildings is likely to have a lower unit cost than that of two separate firms furnishing one building each. The reason for this is that for the former many tasks have to be accomplished only once, independently of the order's size. In other words, there may exist some fixed costs, such as transportation (up to a certain capacity), inspection and interior design, which may vary only slightly when two buildings are to be refurbished rather than just one.

If both contracts were awarded simultaneously albeit separately, production costs for any of the economic operators would depend on whether the operator is awarded one lot or two lots. This uncertainty exposes each economic operator to a high risk in the bidding process: if it bids a price that is lower than the cost it would bid for a single contract (speculating that it will also be successful in the other bidding), it may nevertheless end up being awarded only one contract – at a bid that is lower than its actual production cost. A conservative bid (i.e. higher than the production cost for a single contract) would guarantee a positive profit if the firm were awarded one lot only. However, the chances of winning are rather low if other firms bid aggressively in order to exploit synergies.

Example 2. Procurement of foodstuffs for school refectories

Even without synergies in production, if there are only a few economic operators competing for several lots, competition among them can be increased by bundling the lots. Let us illustrate this point by the following example. Foodstuffs have to be purchased and delivered to school refectories that are scattered all over the country. Market analysis reveals the existence of two large economic operators, A and B. Firm A has a larger market share in the northern part of the country, whereas firm B is the leader in the southern part of the same country. Procurement officials have to decide whether to split the contract into two lots (north and south) or to have just one national contract.

Suppose that, due to warehouse location, firm A bears a distribution cost equal to EUR 1 for lot N (north) and EUR 10 for lot S (south). Firm B bears production costs equal to EUR 9 for lot N and EUR 1 for lot S. In other words, firm A has competitive advantage in the north, whereas firm B has a competitive advantage in the south, which explains the different market shares in the two regions. To make the exposition simple, assume that both competitors know each other well, namely they are aware of each other's cost structure since they have been competing for quite a while. It is easy to see that awarding the contracts as one bundle lowers the contracting authority's procurement costs.

Since each economic operator knows its rival's costs, awarding the contracts separately would cost the contracting authority EUR 9 for lot N (that is, the highest price A can offer while being sure of getting lot N), and EUR 10 for lot S (that is, the highest price B can offer while being sure of getting lot S). Thus, the total procurement cost is EUR 19 if the contracts are procured in separate tendering processes. In this case, economic operator A would serve lot/contract N and economic operator B would serve lot/contract S. If instead the two contracts were bundled, the contracting authority would pay EUR 11 for both, and economic operator B (that is, the firm with the lower *total cost*) would supply both lots.

Example 2 illustrates an important trade-off: bundling the two contracts in one competitive tendering increases the competition between the bidders and therefore *lowers the price* paid by the procurer. However, the allocation generated by awarding the bundle is not efficient: the economic operators' total production cost would be minimised by awarding the first lot to economic operator A and the second one to economic operator B, which happens to be the case in the two separate tendering processes. This example sheds some light on a more general principle: in the absence of synergies, separate competitive procurement procedures allocate procurement contracts efficiently, whereas bundling may allocate inefficiently, although the latter decreases the total cost borne by the procurer price to be paid by the contracting authority if there are only few bidders. If there are many firms competing for both lots, separate sales are more profitable.

Example 3. Procurement of foodstuffs for school refectories with subcontracting

Let us consider a slightly modified version of example 2 above by assuming that there exists an efficient, medium-sized firm (call it firm C), which is located in the southwest part of the country. Firm C would fulfil the economic requirements to participate in competitive tendering for lot S, but not for the national contract S+C.

Suppose that A and C were in a position to negotiate for a subcontract, according to which 50% of food delivery in the south would be allocated to C, which operates at a cost of EUR 5 (southwest and southeast are equally large). When bidding for the national lot, economic operator A would now bear a cost of EUR 1 for lot N and a cost of EUR 7.5 for lot S. The latter results from the fact that A would still take care of 50% of the contract in the southeast (at a cost of EUR 10), while it would subcontract the southwest part of the contract to firm C. So it is as if firm A were producing at a total cost of $\text{EUR } 1 + (\text{EUR } 10 + \text{EUR } 5)/2 = \text{EUR } 7.5$. Consequently, economic operator A would now be awarded both lots at a price of EUR 10 which yields EUR 1 of savings to the contracting authority.

Example 3 illustrates that, while bundling may exclude smaller firms from bidding directly for the procurement contract, it does not prevent them from executing part of the contract. Once again, a trade-off between revenue and efficiency arises: bundling lots generally does not hurt from a savings perspective in the presence of efficient after-market trade (subcontracting). The reason is that large economic operators, when formulating their financial offers, anticipate the additional expected cost savings from subcontracting parts of the project to smaller firms. Thus, the existence of efficient medium-sized and/or small-sized firms lowers the procurement cost, even if the latter are not able to bid directly for the procurement contract.

Let us summarise some of the main conclusions reached so far.

Guidelines on lot design: savings and efficiency

- Bundling is to be preferred when strong synergies in production are expected (due, for example, to high fixed costs).
- If the contracting authority's main goal is to maximise savings, then bundling should be preferred if the number of economic operators is small or if after-market trade (subcontracting) occurs smoothly, whereas lots should be awarded separately if the number of economic operators bidding is large.
- If the contracting authority's main goal is efficiency, then procurement contracts should be split into multiple lots (to foster participation) if production synergies play a negligible role.

2.3 DIVISION INTO LOTS AND PARTICIPATION

In some circumstances, higher participation is associated with more intense competition. In general we should expect a firm to participate in the procurement market if its expected profit from the tendering process is high enough relative to its bidding cost and its outside options (*e.g.* bidding elsewhere or not bidding at all). Thus, the question we have to address is: how to split the contract into lots in order to increase the expected profit of *potentially new* economic operators while at the same time leaving untouched the (participation) incentives of *incumbent* economic operators?

The question is not an easy one since firms are heterogeneous, and therefore driven to participate by quite different incentives. Firms can be distinguished by:

- their size (large vs. small);
- whether or not they already have an established position in the market (incumbent vs. entrant).

2.3.1 Size

Small and medium-sized enterprises (SMEs) usually do not have sufficient capacity to execute the whole contract on their own. Thus, by designing large lots, the contracting authority may exclude smaller firms from the competitive process. However, in many cases the participation of SMEs is desirable. Often highly specialised smaller firms are more efficient than large firms in executing at least certain parts of the project. Moreover, they increase competition on the lots they bid on, which lowers the expected cost. Finally, the existence of smaller economic operators may hamper collusive strategies among bigger players in the market.

The arguments just outlined above favour the division of the procurement contract into many small lots. On the other hand, the existence of complementarities between lots may induce economic operators to bid more aggressively for a bundle. This argument favours a bundled contract. The two opposite forces should be appropriately weighed case by case in order to reach the most appropriate contract strategy.

2.3.2 Incumbent economic operators and new entrants

If the group of potential economic operators that which will compete comprises both well-established firms and new entrants, the tendering process should be designed so that the latter perceive a reasonable chance of success. It may happen that the contracting authority is uncertain whether new entrants are in fact more efficient than incumbents, and therefore designing the competitive process in order to ensure equal entry does not necessarily sound attractive in terms of expected purchasing cost. However, if experience plays any role in correctly executing the procurement contract, then learning-by-doing might put new (small) economic operators in a position to be more competitive in the future. Consequently, splitting the contract into several lots may achieve two goals at the same time: fostering current participation and increasing competition in the future. Contracting authorities must ensure that decisions on division into lots and also on bundling do not favour national suppliers, are non-discriminatory, and ensure equal treatment of all participants in the tendering process.

See module E5 for further discussion on SMEs and procurement.

2.4 DIVISION INTO LOTS AND COLLUSION

Broadly speaking, collusive agreements among economic operators aim to soften price competition. There are several collusive strategies for achieving such an outcome. When procurement contracts are split into several lots, (colluding) economic operators attempt to share the pie, that is, to decide in advance which firm is going to bid on which lot as well as the financial offers to be submitted. Intuitively, each cartel member has to get a slice of the pie at a price that is high enough to deter it from cheating, that is, from taking the whole pie by undercutting its fellow conspirators.

Successful co-operation between firms (that is, collusion) requires three main ingredients:

1. agreement on prices/quantities;
2. effective monitoring of rivals' actions;
3. enforcement, that is, the ability to punish deviant behaviour.

Enforcement is a crucial dimension. Conspiring economic operators have to find it more profitable to adhere to the collusive strategy rather than cheating on the other conspiring economic operators in order to get a bigger share of the pie. Adherence to a collusive strategy can be maintained only if cheating triggers retaliation in future market interactions. Thus collusion requires repeated interactions over time.¹

The effect of division into lots on the risk of collusion among economic operators can be explored by considering the following dimensions:

- Number of participants
- Symmetry
- Nature of tendering format
- e-auctions

¹ The appendix at the end of this section provides a more formal, albeit simple, economic framework to study how co-operation may arise between self-interested participants.

2.4.1 Number of lots and participants

For a given number of lots, the larger the number of participants the lower the risk of collusion, as the size of a would-be cartel increases, it is increasingly difficult to agree on how to split the lots. However, varying the number of lots does affect participation since economic requirements are positively linked with the contract value of a single lot. Thus the risk of collusion does vary with the number of lots, as explained in the following example.

Example 4. Lots and participation

A procurement contract for cleaning services could be split into several geographical lots. The value of the contract is such that if only one (national) lot is awarded, no firm would be able to participate because of its limited size (and/or turnover). If the contract was split into two lots, then two firms would be in a position to compete; finally, if the contract was split into three lots, then seven firms would fulfil the economic requirements. If the contracting authority aims to minimise the risk of collusion, then the contract should be split into three lots.

2.4.2 Symmetry

Symmetric economic operators (i.e. of similar capacity/dimension/market shares) find it easier to split *symmetric* lots (of similar economic value); in contrast, they find it more difficult to split asymmetric lots. In general, each conspirator's bargaining power within the cartel is proportional to its relative position in the relevant market. Therefore, to prevent collusion, the contracting authority should split the contract in such a way as to create some asymmetries between economic operators and between lots.

The discussion developed so far leads to quite a natural policy for procurement design, as indicated in the guideline below.

Guideline on the number of lots and collusion

- The number of lots should always be smaller than the expected number of participants.

Some contracting authorities use the above guideline as a simple rule of thumb to prevent economic operators from colluding by sharing lots. This guideline is indeed useful, but it would be unwise to believe that collusion may be successfully sustained only when the number of lots is high enough. Even when the number of lots falls short of the number of economic operators, collusive agreements may be implemented through rotation schemes, where tendering processes are typically repeated over time. Moreover, since many firms operate in more than one market, collusion can be sustained by multi-market sharing agreements.

Collusive gains can also be shared by taking turns in winning procurement contracts or through side transfers, such as subcontracting; economic operators could agree in advance on the winning firm and on the conditions for the award of subsequent subcontracts to the others. There are definitely tendering processes in which the technical aspects of the procurement contract require a very large number of lots, which makes it impossible to follow the above guideline; as we will see, in those cases a large number of lots may even hinder collusive behaviour.

Most importantly, it should never be forgotten that participation is *endogenous*, i.e. it depends on the number and size of lots, as well as on all of the other elements of the tender design. Therefore, it is far from clear that reducing the number of lots will reduce the risk of collusion, as this may be counterbalanced by potential lower participation, which in itself favours collusion.

2.4.3 Nature of the tendering format

Once contracting authorities have decided on the most appropriate division into lots, one additional issue is to be addressed: should the lots be awarded *simultaneously* or *sequentially*? The following example can help to illustrate the two alternatives.

Example 5. Simultaneous vs. sequential tendering format for multiple lots

Suppose that a contracting authority wishes to buy 1,000 laptops, 500 monitors, 1,000 printers and 50 servers. Market analysis shows that four firms (A with an average market share in the relevant markets of 40%, B and C with market shares of 15%, and D with 10%) are in a position to supply all four types of products. Procurement officials are nonetheless reluctant to award the contract as a bundle since they are not sure whether the firm D would fulfil the economic requirements. Thus the contract will be split into four lots, one for each product category. Two competitive tendering formats could be adopted:

Simultaneous: firms are requested to submit at the same time four bids;

Sequential: firms bid for laptops first; once the economic operator has been selected, they then submit bids for monitors, and so on.

If the risk of firms co-ordinating to split the four lots is significant, can the choice of a simultaneous rather than sequential tendering format be of help?

There are two ways in which a sequential format may facilitate collusion between economic operators compared to a simultaneous one. The first, intuitive collusive drawback of sequential competitive procurement is linked to the ability of cartel members to identify defections and to react quickly, within the same sequence. This situation limits the defector's short-run gains, thereby facilitating the enforcement of collusion in comparison to a simultaneous format. In the case of the procurement of related goods, this effect can be seen as an increase in the frequency of interaction. The effect is stronger the larger the number of related goods that are sequentially procured (or the smaller the lots in which given divisible goods are fractioned before being procured). The second way that a sequential format facilitates collusion is linked to the possible asymmetry within a cartel of colluding economic operators. The viability of cartels is often limited by the presence of 'mavericks', i.e. firms that are difficult to discipline as they have more to gain from undercutting a cartel (or less to gain from being part of it). This is the case of firm A in example 5 above. If economic operators are asymmetric, a sequential competitive tendering can facilitate collusion by allowing the cartel to soften the maverick's aggressiveness by allocating to that economic operator the last object(s) in a given sequence. This action minimises the maverick's incentive to defect and strengthens the viability of the cartel.

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SECTION 3 EXERCISES

EXERCISE 1 CENTRALISED AND DECENTRALISED PROCUREMENT

Group discussion. Divide into groups and discuss the following questions:

1. Would a fully centralised procurement strategy for pencils automatically guarantee tougher competition among participating tenderers? Why?
2. Why would green procurement strategies require a centralised rather than a decentralised approach?
3. Would the increasingly widespread use of electronic tools favour decentralised procurement strategies? Explain.

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EXERCISE 2

PROCUREMENT CONTRACTING STRATEGIES – FIXED-PRICE BUT NOT PERFORMANCE-ORIENTED CONTRACTS FOR CLEANING SERVICES

Procurement contracts for cleaning services are normally rewarded on a fixed-price basis (say, EUR XX per square meter). Are they really performance-based contracts? If not, how could they be made (more) performance based?

Action: Prepare a list of at least 5 quality standards you could include in the specification that are performance-based standards.

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EXERCISE 3

THE DESIGN OF THE COMPETITIVE TENDERING FORMAT COMPETITION WITH SEALED BIDS AND E-AUCTIONS – “INCUMBENT EFFECT” IN A PROCUREMENT CONTRACT FOR AMBULANCES

A central purchasing body is planning to award a new, two-year contract for purchasing ambulances on behalf of five different hospitals scattered over a vast region. The procurement strategy hinges on two points: tenderers are asked to submit offers both for a “basic model” of ambulance and for a catalogue of specialised accessories to add to a basic model ambulance that can be selected by each hospital according to their specific needs. For example, a hospital based in a ski resort may require an ambulance with equipment suited to use in snowy conditions.

Two previous (two-year) contracts have been awarded to the same firm.

What advice you can provide to procurement officials so as to reduce the possible competitive advantage that the incumbent contractor has gained over the past four years?

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EXERCISE 4

THE DESIGN OF THE COMPETITIVE TENDERING FORMAT

COMPETITION WITH SEALED BIDS AND E-AUCTIONS – “LAST-MINUTE BIDDING” IN E-AUCTIONS

Having used e-auctions (with a fixed deadline) for a while, procurement officials have been observing a slow price dynamic – that is, bids being reduced by small amounts – together with several cases of “last-minute bidding”. In order to get round such a problem, they are planning to introduce a slight variant: if any bid is recorded within five minutes before the deadline, the latter is extended by 30 additional minutes.

Would this be enough to make a dynamic auction more “lively”? – that is, would it induce more informed bidders to bid more aggressively? Explain.

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EXERCISE 5

SPLITTING CONTRACTS INTO LOTS – FIRMS' HETEROGENEITY

Two local authorities, L1 and L2, wish to award a contract for car rental services in the same period. The value of L1's contract is EUR 500 000, while L2's is EUR 1 million. Two leading firms operate in the market: firm A with a market share of 65%, and firm B with a market share of 35%.

What advice would you give L1 and L2 as to whether or not to award two separate contracts?

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EXERCISE 6
SPLITTING CONTRACTS INTO LOTS – LOTS AND PARTICIPATION

A procurement contract for cleaning services could be split into several geographical lots. The value of the contract is such that if only one (national) lot is awarded, only one large firm would be able to participate. If the contract were split into two lots (of equal value), then three firms would be in a position to compete. Finally, if the contract were to be split into three lots (of equal value), then seven firms would fulfil the economic requirements.

Which division into lots would you favour if you were asked to minimise the risk of collusion among participants?

SECTION 4 CHAPTER SUMMARY

SELF-TEST QUESTIONS

Centralised and decentralised procurement

1. What key elements of centralised procurement will help to reduce purchasing costs?
2. Does centralisation help to reduce or in fact increase the risk of favouritism?
3. What areas of strategic procurement are commonly centralised, and why?

Procurement contracting strategies

4. What kind of (procurement) risk can a public institution transfer to the economic operator by adopting a fixed-price contract?
5. What economic factors should procurement officials consider when designing the number of quality improvement thresholds in a quality incentive contract?
6. Can you provide some examples of non-verifiable quality dimensions?

The design of the competitive tendering format – Competition with sealed bid and e-auctions

7. What is a private dimension in a cost component in production costs?
8. What is a common dimension in a cost component in production costs?
9. In a rental and maintenance contract for photocopiers, what might be the most important common components in tenderers' costs?
10. Under what conditions is information circulation in an e-auction good for competition?

Splitting contracts into lots

11. What are the two key consequences of division into lots in terms of levels of participation in the process?
12. What key factors should contracting authorities consider in deciding on the number and configuration of lots?
13. Is it true that awarding several lots sequentially rather than simultaneously makes collusion more difficult because each colluding firm may end up receiving a "smaller slice of the pie"? Why?

APPENDIX A SIMPLE ECONOMIC MODEL OF CO-OPERATION IN MARKETS

This appendix provides a brief theoretical overview of how co-operation may arise among selfish (that is, self-interested) economic agents. Although we use a very simple model of interaction, some of the main insights about collusion in stylised markets are nearly in a ready-to-use form for application in procurement markets.

A.1. **A stylised model of static competition: The ‘prisoners’ dilemma’**

One of the most frequently mentioned example for studying the scope of co-operation/collusion is the ‘prisoners’ dilemma’.

Example A1. ‘The Prisoners’ Dilemma’

“A pair of transients, Al Fresco and Joe Prison, have been arrested for vagrancy. They are suspected of complicity in a robbery, but the evidence is inadequate to convict them. The district attorney interrogates them in separate cells and offers each the following deal. ‘If you confess and your friend does not, you will be released and your friend will have the book thrown at him; and the other way if he confesses and you do not. If both confess, both will receive moderately long sentences. If neither confesses, both will be convicted of a minor vagrancy charge.’ Specifically, the promised jail sentences, in months, are in the following table, with the first number in each pair representing Al’s sentence and the second Joe’s. (A minus sign is put in front of each of the numbers to remind us that, in the reverse of the usual interpretation, here more is worse.)”

Table 1: Prisoners’ Dilemma

		JOE	
		Confess	Don’t Confess
AL	Confess	(-8, -8)	(0, -15)
	Don’t Confess	(-15, 0)	(-1, -1)

What is the logic of the situation represented in Table 1? Imagine Al’s reasoning process; should he confess or not? If Al believes, for whatever reason, that Joe is going to confess, then (reading down the first column) Al sees that he has a choice between eight months in jail (if he confesses) and 15 months in jail (if he does not confess). Confessing is clearly his best strategy. If, on the other hand, Al believes that Joe will not confess, then (reading down the second column) Al sees that his choice is between going free (if he confesses)

and one month in jail (if he does not confess); again, confessing is the best choice for him. Although, when working through the logic of the situation, Al had to make conjectures about what Joe would do, in the end these conjectures were irrelevant. Regardless of what Joe does, Al's best action is to confess. Now notice that Joe is exactly in the same situation as Al, and so Joe reaches the same conclusion; Joe also rationally confesses. Thus *the equilibrium* of this game (more precisely, the *Nash equilibrium*), the outcome of *simultaneously rational decisions by both of the players*, is that both of them confess.

This outcomes seems to be paradoxical. Compare the confess/confess equilibrium (which results in eight months' jail for each) with the alternative of neither of them confessing (which results in one month's jail for each). Both would be better off if neither confessed. There is a contradiction between what is individually rational and what is collectively rational. The pursuit of individual gain results in both being worse off than they need to be. Each would be better off if they could succeed in co-operating, but they cannot. If one decided to act in their mutual interest by not confessing, then, according to the logic already given, it is in the interest of his rival to confess.

Let us introduce some economics jargon to describe the situation. We will call an outcome 'efficient' if there is no alternative outcome that would leave some players better off and none worse off. To reverse this definition, an outcome is inefficient if there is another outcome that the players unanimously prefer. In the prisoners' dilemma, the (-1, -1) outcome is efficient (just as, for that matter, are the (-15, 0) and (0, -15) outcomes). We have seen that the equilibrium of the prisoners' dilemma game is inefficient.

What the prisoners' dilemma shows is that people who fail to co-operate for their own mutual benefit are not necessarily foolish or irrational; they may be acting perfectly rationally. The prisoners' dilemma is a paradigm for many diverse business and economic interactions. For example, two firms are competing to sell the same product. The logic of profit maximisation forces each to set a low price when both would earn more profits if each set a higher price. Two nations trading with each other are driven by rational, national-interest motivations to erect trade barriers, when both would be better off if these barriers were eliminated. Fishermen overfish their common fishing ground and destroy the industry, to everyone's loss. A potential contracting authority and a potential seller bargain so hard that they fail to reach a potential agreement on a price, despite the fact that there are prices that would make them both better off had the sale occurred.

A.2. **Modelling repeated interaction and incentives to co-operate**

One of the main features of the basic version of the 'prisoners' dilemma' is that the participants play only once. Being a metaphor of real world competitive situations, it clearly lacks one main feature, namely the interaction of participants over time. The question that we are going to address in this section may sound a bit obvious: *are there any other rational patterns emerging when people interact repeatedly?* The main answer that our analysis is going to deliver is that co-operation may emerge as a rational behaviour among completely selfish (i.e. self-interested) participants. To put it in a more business-friendly jargon, competing economic operators may find it mutually profitable to soften competition in order to achieve a better outcome (that is, higher profits).

We will maintain a stylised competitive situation in which two participants – namely the two suspects in the prisoners' dilemma – interact for an infinite number of times. This may sound like quite an unrealistic assumption, as one of the properties of infinitely repeated games is that the stage game is played each period for an infinite number of periods. Although such a game may not seem realistic at first (people do not live forever), infinitely repeated games are useful for modelling some real-world situations. Consider an infinitely repeated game with *discounting*, whereby the payoffs in the stage game are discounted over time. Let us use δ (a number between 0 and 1) to denote the discount factor. When comparing a payoff received today with a payoff received tomorrow (the next period), we discount tomorrow's payoff by multiplying it by the discount factor. In this way we say that the stream of payoffs – from today and tomorrow – are 'discounted to today'. Payoffs obtained two periods from now are discounted by δ^2 , payoffs obtained three periods from now are discounted by δ^3 , and so on.

For infinitely repeated games, we will have to calculate the sum of the stream of discounted payoffs. For example, a player may obtain one unit each period for an infinite number of periods. In this case, the sum of the player's discounted payoff stream is the following:

$$s \equiv 1 + 1\delta + 1\delta^2 + 1\delta^3 + \dots = 1 + \delta + \delta^2 + \delta^3 + \dots$$

We can simplify this expression by noting that:

$$\delta + \delta^2 + \delta^3 + \dots = \delta [1 + \delta + 1\delta^2 + 1\delta^3 + \dots] = \delta s$$

Therefore, we have:

$$s \equiv 1 + \delta s,$$

which means that $s = 1/(1 - \delta)$. In summary,

$$1 + \delta + \delta^2 + \delta^3 + \dots = \frac{1}{1 - \delta}.$$

This expression will come in handy. Note that, by multiplying both sides by any constant number a , we have:

$$a + a\delta + a\delta^2 + a\delta^3 + \dots = \frac{a}{1 - \delta}.$$

The strategies in infinitely repeated games can be exceedingly complex. In general, a player's strategy is a full description of which action to take at every information set for every period t and every different history of play from the beginning of the game through period $t-1$. Thus, a strategy prescribes an action for a player to take that is conditional on everything that took place in the past. Fortunately, it is often sufficient to consider just a few types of simple strategies in repeated games. The simplest are those that prescribe stage Nash profiles in each period.

To capture the idea of reputation, we can examine another simple type of strategy called a *trigger strategy*. Trigger strategies specifically refer to two action profiles for the stage game: one profile is called the ‘co-operative profile’, and the other is called the ‘punishment profile’. The punishment profile is assumed to be a stage Nash profile. In a trigger-strategy equilibrium, the players are supposed to play the co-operative profile in each period. However, if one or both of them deviate from the co-operative profile, then they play the punishment profile forever after. In other words, deviating from the co-operative profile destroys a player’s reputation and triggers the punishment profile for the rest of the game.

To see how this works, consider a modified version of the infinitely repeated prisoners’ dilemma studied in the previous section. The stage game is given in Table 2 below. There is only one stage Nash equilibrium (D, D), so we can use it as the punishment profile. Let (C, C) be the co-operative profile. Our goal is to understand whether the players have the incentive to play (C, C) each period under the threat that they will revert to (D, D) forever if one or both of them cheat. To be precise, the trigger strategy specifies that the players select (C, C) each period as long as this profile was already played in the past; otherwise, they will play (D, D). This is sometime called the *grim-trigger strategy*.

Table 2: Prisoners’ Dilemma

		2	
		C	D
1	C	(1, 1)	(0, 3)
	D	(3, 0)	(1, 1)

Let us evaluate whether the grim-trigger strategy is a Nash equilibrium of the infinitely repeated game. Consider the incentives of players i ($i = 1, 2$) from the perspective of period 1. Suppose the other player – player j – behaves according to the grim trigger. Player i basically has two options. First, he/she can also follow the prescription of the grim trigger, which means cooperating as player j does. In this case, player i obtains a payoff of 2 each period, for a discounted total of:

$$2 + 2\delta + 2\delta^2 + 2\delta^3 + \dots = \frac{2}{1 + \delta}.$$

Second, player i could defect in the first period, which yields an immediate payoff of 3 (the highest discounted defection payoff) because player j co-operates in the first period. However, player i ’s defection induces player j to defect in each period, starting in the second period. Thus, by defecting in period 1, player i obtains the payoff:

$$3 + \delta + \delta^2 + \delta^3 + \dots = 3 + \delta [1 + \delta + \delta^2 + \delta^3 + \dots] = 3 + \frac{\delta}{1 + \delta}.$$

If $2/(1-\delta) \geq 3 + \delta/(1-\delta)$, then player i earns a higher payoff by perpetually co-operating according to the grim trigger rather than defecting in the first period. Simplifying this inequality yields:

$$\delta \geq \delta^* = \frac{1}{2}.$$

The grim-trigger analysis applies to the repeated prisoners' dilemma, although the 'cutoff discount factor' (that is, δ^*) depends on the payoffs in the stage game.

Let us try to generalise the result that we have just proven. First, any two-player strategic game, such as the one in Table 3 below, represents a prisoners' dilemma if, and only if, the relevant payoffs are such that: $\Pi_B < \Pi_D < \Pi_C < \Pi_O$.

Table 3: Generalised Prisoners' Dilemma

		2	
		C	D
1	C	(Π_C, Π_C)	(Π_B, Π_O)
	D	(Π_O, Π_B)	(Π_D, Π_D)

The condition for the discount factor now becomes:

$$\delta \geq \delta^* = \frac{\Pi_O - \Pi_C}{\Pi_O - \Pi_D},$$

that is, collusion is easier to be sustained (*i.e.* the threshold value is low): i) the closer the payoff for unilateral opportunistic behaviour to the payoff for co-operation ($\Pi_O - \Pi_C$ is low); and ii) the lower the punishment payoff (Π_D). In most economic situations, however, payoffs are not exogenously given as in a prisoners' dilemma, but they are endogenously determined, as they are the outcome of firms' choices about price/quantity. Consequently, the 'size of the pie' to be divided among conspiring firms as well as the profit levels when cheating occurs depend on several factors, such as market conditions, the degree of asymmetry between firms' size, and other institutional factors.



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