

**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE****Global Forum on Competition****COMPETITION FOR-THE-MARKET: TACKLING THE INCUMBENCY
ADVANTAGE****- Paper by Elisabetta Iossa -****6 December 2019**

This paper by Elisabetta Iossa was submitted as background material for Session IV at the 18th Global Forum on Competition on 5-6 December 2019.

The opinions expressed and arguments employed herein do not necessarily reflect the official views of the Organisation or of the governments of its member countries.

More documentation related to this discussion can be found at: oe.cd/cmkt.

Please contact Mr. Chris Pike [E-mail: Chris.Pike@oecd.org] and Ms. Lynn Robertson [E-mail: Lynn.Robertson@oecd.org], if you have any questions regarding this document.

JT03454356

Competition for the market: tackling the incumbency advantage

- Paper by Elisabetta Iossa* -

When designing contracts and tenders for the provision of public services, governments should tackle incumbency advantage, which may constitute an important obstacle to the well functioning of competition for the market. In this note, we briefly discuss the different instruments that can be used to ensure a level playing field at tender stage.

* This note was prepared for the “Global Forum on Competition,” to be held at the OECD. in Paris on 5, 6 December 2019.

Professor of Economics, Department of Economics and Finance, University of Rome Tor Vergata, Rome 00133, Italy; and GREEN-Bocconi. Email: Elisabetta.Iossa@uniroma2.it.

Table of Contents

Competition for the market: tackling the incumbency advantage - Paper by Elisabetta Iossa - 2

1. Introduction 4

2. Background Economic Theory..... 4

3. In practice 5

4. What to do..... 6

5. Conclusions 8

1. Introduction

1. Recent years are witnessing a progressive opening up of the provision of public services to competitive tendering, possibly in response to economic arguments in support of competition, or simply due to the desire to reduce direct public involvement in the face of tighter government budgets.

2. A comprehensive analysis of the impact of competitive tendering is currently not available. However, instances have been reported where lack of effective competition has been observed. In Europe, between 2006 and 2016, the number of public tenders with only one bid has grown from 17 percent to 30 percent and the average number of offers per tender has fallen from five to three in the same period.¹ There is also evidence of public contracts being repeatedly won by the incumbent firms.² Furthermore, small and medium size firms (SMEs) win only 45 percent of the value of public contracts above EU thresholds, well below their weight in the economy, which may be a sign of increasing concentration in public procurement markets.³

3. In this note, we argue that incumbency advantage may constitute an important obstacle to the functioning of competition and more attention should be devoted to ensuring a level playing field at tender stage, and in particular at the time the market is opened up to competition. Furthermore, the design of contracts and tenders should be guided by the long-term objective of preserving competition over time, even if this involves some short-term inefficiency. We stress the critical role that independent authorities, including competition authorities, should play in achieving these objectives and identify some key instruments to do so.

4. Beyond reducing obvious barriers to entry and exit linked to sunk costs and asset ownership, governments should consider breaking up the incumbent provider; dividing the contract into lots, assigning initially different lots to different firms; choosing the timing of the tenders strategically; ensuring that information on market condition – demand and technology - is available to all bidders prior to tendering; and favour participation of SMEs and new entrants by reducing contract size, unbundling ancillary services from the tender for core services and using bid credits and set aside systems.

2. Background Economic Theory

5. For natural monopolies, the introduction of competition for the market in the provision of public services may be a valid alternative to in-house provision. In a nutshell, the argument put forward by many economists is that competition for the market may be suitable when the nature of the costs are such that a market may be more efficiently served

¹ See European Commission (2017). Evidence of lack of competition in public procurement tenders is also reported at country level. For example, in Finland, Jääskeläinen and Tukiainen (2019) find that more than half of public procurement tenders across sectors exhibit at most two bidders.

² For example, Weiergraeber and Wolf (2018) find that in the German market for short-haul railway passenger services, the former state monopolist (DB Regio3) still operates the majority of the traffic volume (73.6 percent 2015).

³ See European Commission (2017).

by a single firm, the quality of the service is verifiable and therefore it can be contracted upon, and there are opportunity for cost reduction and innovation.⁴

6. Under these *necessary* conditions, competition for the market has the *potential* to yield as follows:

- Profit maximizing firms will have incentives to introduce new processes or technologies that reduce the cost of providing the public infrastructure or service, if they can translate these lower costs into greater profits (as when they are subject to some form of price cap regulation);
- The competitive pressure at tender stage will ensure that the benefit of cost reduction and innovation be passed onto consumers and to public authorities via lower tariffs, lower subsidies and higher service quality, provided that there is effective competition for the contract;
- The public authority will monitor the execution of the contract and ensure that the private firm will not pursue the cost reduction at the expense of quality.

7. The economic debate on Public Private Partnerships (PPPs) has also identified the *necessary* conditions under which it may be efficient to bundle the design, building and management of an infrastructure and procure it from a single contractor (or multiple firms organized in a consortium). In a nutshell, PPPs may be desirable when there are strong positive externalities between the stages of the infrastructure provision, as then bundling induces the contractor to take a long-term perspective and build better infrastructures to reduce operational and maintenance costs.⁵

8. Economists have however also long warned that these necessary conditions are not at all *sufficient* to obtain an efficient provision.

3. In practice

9. In practice, as discussed in the OECD background note (OECD, 2019), a number of factors prevent the benefit of competitive tendering from materializing. These include: badly designed tenders or contracts, barriers to entry, incumbency advantage, incomplete contracts, bid rigging, corruption, lack of monitoring and enforcement of contractual obligations, among others.

10. To enhance competition, independent authorities should take a more active role in advising governments and public authorities on whether to use concessions for certain type of services, how to prepare the market for competition, how to design the contract and the tenders, and how to manage the competitive tendering processes to ensure that it is effective.

11. The intervention of independent authorities is needed as there is an inherent agency problem within the public authorities tendering public services to private firms. This agency problem is linked to: (i) short-termism of the political agenda; (ii) lack of specific

⁴ See for example the seminal paper by Hart, Shleifer and Vishny (1997).

⁵ See Hart (2003), Bennett and Iossa (2006) and Martimort and Pouyet (2008) for studies showing that incentives for cost reduction and quality improvements may be stronger under bundling in the presence of positive externalities across stages.

competencies on procurement of complex contracts; (iii) lobbying by interest groups and corruption.

- *Short termism.* The short-termism of the political agenda induces governments to use outsourcing to overcome immediate budgetary constraints, even if this comes at the cost of future governments and generations. The widespread tricks undertaken to make PPPs contracts artificially “*off balance*” is an example, but more in general this agency problem occurs because concessions are long-term contracts whilst political agendas tend to focus on short-term objectives.⁶
- *Competencies.* Concessions are complex contracts and their procurement requires a multitude of skills, from strategic and economic reasoning, to legal and engineering competences. The shortage of adequate skills, training and incentives among public procurers is however widespread.⁷ Even in countries with a long tradition of professionalism in procurement, it has been shown that the identity of the contracting authority can have a quantitatively significant impact on the performance of the contract in terms of timing and cost overruns.⁸
- *Lobbying and corruption.* Concession contracts can generate significant economic rents, as they are typically large contracts that last for many years, especially when they involve the bundling of design, building and operation into a single tender, as with PPPs. This exposes public authorities to lobbying by interest groups and corruption pressure.

4. What to do

12. The approach taken by many countries in the face of procurement failure has typically been one of redesigning the law on tendering of public contracts to reduce the discretion of public authorities and impose limits to concession contracts based on private initiative, such as “unsolicited proposals”.⁹ However, there is no empirical evidence that this approach is effective.¹⁰ In fact, countries with a wider production of laws are also often

⁶ See Iossa and Saussier (2018) for an informal discussion on PPPs vs traditional procurement.

⁷ Concerns on the lack of competence of public buyers have recently been expressed in Saussier and Tirole (2015).

⁸ Decarolis *et al.* (2019) study to what extent a more competent public procurer contributes to better procurement outcomes, using data on the US federal procurement of goods and services. Based on an instrumental variable strategy, they find that an increase in bureau competence causes a significant and economically important reduction in: i) delays, ii) cost overruns, and iii) number of renegotiations. Cooperation within the procurement office is a key driver of the procurement performance.

⁹ See Hodges and Dellacha (2007).

¹⁰ Furthermore, less discretion of procurers and public authorities may result in worse procurement outcomes. Coviello *et al.* (2018) run a regression discontinuity design analysis to document the causal effect of increasing buyers’ discretion on procurement outcomes in a large database for public works in Italy. Works with a value above a given threshold have to be awarded through an open auction. Works below this threshold can be more easily awarded through a restricted auction, where the procurer has some discretion in terms of who (not) to invite to bid. Their find that discretion does not deteriorate (and may improve) the procurement outcomes observed.

those with weaker institutional efficiency and greater corruption. Furthermore, continuous changes in the legislation create legal uncertainties that disincentivizes private investment.

13. An alternative strategy should be one based on strengthening the competence and the accountability of the public sector and increase the involvement of independent authorities, so as to design standardized tenders and contracts per sector and type of concession, provide benchmarking and performance data for ex-post evaluations, and adequately prepare the market for competition.

14. Preparing the market for competition in turns requires creating the conditions for a level playing field, removing technological and informational barriers to entry and tackling the incumbency advantage that past experience and knowledge of the market may create. If the in-house provider benefits from strong incumbency advantage, as is reasonable to expect in many markets, potential competitors will be discouraged from incurring participation costs and compete for the contract. The public monopoly will be replaced with a private monopoly, locked in.

15. To tackle incumbency advantage, authorities should consider breaking up (and possibly also privatize) the incumbent provider and divide the contract into lots assigned initially to different firms, even if this come at the cost of some short-term inefficiency. Dividing contracts into lots, and awarding initially different lots to different firms, can help to enhance the competitive pressure that comes within the market from the other active firms, as these are also acquiring knowledge and information to compete effectively in future tenders.^{11 12}

16. Procurers should then coordinate the award of contracts for the same service in different cities, or for similar services across cities, as tendering timing may affect the likelihood that competition will be preserved or that there will be instead monopolization. In fact, the timing of tenders should depend on the likelihood of monopolization. Monopolization always yields higher prices than when there is more than one active firm in the market, but it will arise over time if the incumbency advantage is large or the discount factor is large, as firms will have incentives to bid aggressively to become the sole provider and then enjoy large future rents.

17. When monopolization is expected, synchronous tendering is preferable, as it strengthens the pressure that entrants exercise on the incumbent monopolistic provider. When instead other firms remain active, staggered tendering maximizes the competitive pressure that comes from the other firms and therefore may be more conducive to future competition.¹³

¹¹ The importance of dividing contracts into lots was for example stressed by the Italian Competition Authority in a study on the tendering for local transport services in Italy, AGCM (2016).

¹² With over 600 routes, and over two billion passenger journeys annually, the market for local public services in London is a very large one. Aiming to facilitate competition for the market, the UK Government chose in 1992 to break up and privatize the London historical operator, creating 13 firms, each related to particular garaging facilities (see Amaral et al., 2013). It then allowed the firms to compete through a tendering process on a route-by-route basis. Since 2001, tender competition has been on a gross cost basis, fares going directly to the organizer, Transport for London (TfL). Despite a number of acquisitions, entry and exit, to date the London market appears to remain competitive. There are around 10 companies active in the market, with five having a share greater than 10 percent (Iossa and Waterson, 2019).

¹³ Iossa, Rey and Waterson (2018) show this building a theoretical model of repeated procurement in the presence of incumbency advantage. Beyond helping in case of incumbency advantage when

18. Awarding more gross contracts – which do not transfer demand risk to the contractor- can also be desirable to reduce the incumbency advantage stemming from knowledge of past demand information. As gross contracts eliminate the common value component from the auction, they reduce the informational advantage of the incumbent at tender stage.¹⁴ Taking away demand risk from the contractor may however generate the undesirable effect of reducing its incentives to invest in service quality, unless the contract can incentivize the contractor effectively through key performance indicators.

19. Aside incumbency advantage considerations, authorities should aim to preserve competition in the long run by incentivizing participation of SMEs and new entrants. To this aim, shorter and more frequent contracts can help (albeit they may facilitate bid rigging¹⁵). For the same reason, services that are ancillary, e.g. porter services, parking, or catering services, should be unbundled from the core contract and tendered separately. Bidding credit in favour of SMEs can also help to maintain long-term competition.¹⁶

5. Conclusions

20. The background note prepared by the OECD (OECD, 2019) has addressed many of the issues that are relevant for organizing competition for the market. In this note, we have therefore chosen to stress the need to prepare the market for competition prior to opening it up to competitive tendering, tackling incumbency advantage problems and designing tenders and contracts with a long term perspective aimed at preserving competition over time. This calls also for a more central role of independent authorities to ensure a long-term perspective focused on enhancing and preserving competition.

monopolization is expected, using synchronized tendering is useful to increase competitive pressure in the presence of economies of scale (see Cabral, 2017). Iossa, Marx, Loertscher and Rey (2019) consider a theoretical model of repeated procurement and show that synchronous tendering also helps to deter bid-rigging through market or customer allocation, compared to staggered tendering.

¹⁴ Weiergraeber and Wolf (2018) use a detailed data set on tenders in the German market for short-haul railway passenger services from 1995 to 2011 to build a structural model to estimate whether the dominance of the former state monopolist (DB Regio3) is justified by an efficient cost structure or by a strong informational advantage. Their estimation of the informational advantage of DB over its competitors reveals that indeed in most auctions DB has significantly more precise information about future ticket revenues.

¹⁵ On how to fight bid-rigging in procurement see e.g. O.E.C.D. (2009).

¹⁶ Albano et al. (2006) note that in many circumstances the higher the number of lots/contracts the higher the participation in a competitive tendering.

References

- AGCM (2016), *Condizioni Concorrenziali Nei Mercati Del Trasporto Pubblico Locale*,” Autorità Garante della Concorrenza e del Mercato, Rome, Italy.
- Albano, Gian-Luigi and Dimitri, Nicola and Perrigne, Isabelle M. and Piga, Gustav, “Fostering Participation in Competitive Procurement,” *Handbook of Procurement*, Nicola Dimitri, Gustavo Piga, Giancarlo Spagnolo, eds., Cambridge University Press, 2006. Available at SSRN: <https://ssrn.com/abstract=896739>
- Amaral, Miguel, Saussier Stéphane and Anne Yvrande Billon (2009), “Auction procedures and competition in public services: The case of urban public transport in France and London, *Utilities Policy*, 17(2): 166-175.
- Bennett John and Elisabetta Iossa (2006). “Building and Managing Facilities for Public Services,” *Journal of Public Economics*, 90 (10-11): 2143-2160.
- Cabral, Luis (2017), “Staggered Contracts, Market Power, and Welfare,” *Mimeo*, Columbia University.
- Coviello Decio, Guglielmo Andrea and Giancarlo Spagnolo, (2018), “The Effect of Discretion on Procurement Performance,” *Management Science*, 715–738.
- Decarolis, Francesco, Giuffrida Leonardo, Iossa Elisabetta, Mollisi Vincenzo and Giancarlo Spagnolo (2017) “Bureaucratic Competence and Procurement Outcomes”. Previous title: Buyer Quality and Procurement Outcomes: Evidence From the US”. *NBER Discussion Paper 24201*.
- European Commission (2017), “Making Public Procurement work in and for Europe,” Communication from the Commission to the European Parliament, The Council, The European Economic and Social Committee and The Committee of the Regions. Strasbourg, 3.10.2017. COM(2017) 572 final.
- Hart, O. Shleifer, A. and Vishny, R. W. (1997), “The Proper Scope Of Government: Theory And An Application To Prisons,” *Quarterly Journal of Economics*, 112: 1119-58.
- Hart, Oliver. (2003), ‘Incomplete Contracts and Public Ownership: Remarks and an Application to Public-Private Partnerships,’ *Economic Journal*, 113: 69-76.
- Hodges, John T., and Georgina Dellacha (2007), "Unsolicited Proposals: How Some Countries Introduce Competition and Transparency," Working Paper n° 1, PPIAF, The World Bank.
- Iossa, Elisabetta and Mike Waterson (2019) “Maintaining Dynamic Competition in Procurement: The Case of London Bus Tendering”. *Transport Policy*, Vol. 75: 141-149. (VQR: A)
- Iossa, Elisabetta and Stephane Saussier (2018), “Public Private Partnerships in Europe for Building and Managing Public Infrastructures: An Economic Perspective,” *Annals of Public and Cooperative Economics*. (Invited paper). Vol. 89, 1: 25-42.
- Iossa, Elisabetta and David Martimort (2015), “The Simple Micro-Economics of Public Private Partnerships, *Journal of Public Economic Theory*, Volume 17, (1), 4–48.
- Iossa, Elisabetta, Loertscherz Simon Marx Leslie M. and Patrick Rey (2019), “Collusion via Market Allocation,” *Mimeo*.
- Iossa, Elisabetta, Rey Patrick and Mike Waterson (2018), “Organizing Competition for the Market,” *C.E.P.R. Discussion Paper* 13461.
- Jääskeläinen Jan and Janne Tukiainen (2019), “Anatomy of public procurement, *Mimeo*, Aalto University School of Business.
- Martimort David and Jerome Pouyet (2008), “To build or not to build: Normative and positive theories of public–private partnerships,” *International Journal of Industrial Organization*, 26: 393-411.
- OECD. (2009), *Guidelines on Fighting Bid Rigging in Public Procurement*, O.E.C.D. Paris.
- OECD (2019), *Competition for the market*. Background note prepared by the Secretariat. O.E.C.D., Paris.
- Saussier, Stephane, and Jean Tirole, (2015), “Strengthening the Efficiency of Public Procurement.” *Counseil d'Analyse Economique*, 22.
- Weiergraeber, Stefan and Christoph Wolf (2018), “Bidder Asymmetries in Procurement Auctions: Efficiency vs. Information, *Mimeo*, Bocconi University.