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**HEARING ON AUCTIONS AND TENDERS: FURTHER ISSUES**

-- Note by the Secretariat --

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

Please contact Ms. Ana Rodrigues or Ms. Cristiana Vitale if you have any questions regarding this document [E-mail: [ana.rodrigues@oecd.org](mailto:ana.rodrigues@oecd.org) or [cristiana.vitale@oecd.org](mailto:cristiana.vitale@oecd.org)].

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## HEARING ON AUCTIONS AND TENDERS: FURTHER ISSUES

*By the Secretariat\**

### 1. Introduction<sup>1</sup>

1. Public Procurement accounts, on average, for 13% of GDP in OECD countries, and it represents almost 30% of government expenditure (OECD, Government at a glance, 2013). The share of the economy involved is thus overwhelming. The role that competition can play in ensuring public procurement efficiency cannot be overstressed. One of the potential competition concerns emerging in public procurement is bid rigging, which entails cartel-outcomes with substantial welfare costs. This has been a central area of OECD work<sup>2</sup>.

2. However, the role that competition can play in promoting efficient outcomes is not confined to issues of bid rigging. Auctions and tenders can only ensure optimal outcomes if they are designed so as to capture the benefits of the competitive process among firms.

3. Governments may care about competition in a tender in many ways. They may, as buyers, want to spur firm interaction within the current tender so as to achieve the most favourable price and quality pair according to their buyer preferences. In the case of contracts which are periodically re-tendered, governments may seek to promote competition in future tenders. They may also use public procurement as a strategic tool to promote competition “in the market”. This will bring welfare gains for the government as a buyer, but also benefits to other consumers in the market. Governments may also use public procurement as an instrument to achieve other strategic goals, such as promoting SMEs.

4. The Working Party 2 on Competition and Regulation has previously addressed the design of auctions and tenders to achieve efficient outcomes and provide winners with the incentives to deliver quality<sup>3</sup>. As a follow up on the work done, the current note goes deeper into the discussion of some specific tender issues, namely i) the concept of “*Abnormally Low Tenders*” (ALTs), and associated rules, which emerged in procurement systems and case law, and ii) the instrument of *Partitioning Public Procurement Contracts into Lots*, which follows, among other things, from the increasingly strategic role of public procurement in promoting SMEs.

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<sup>1</sup> This note was prepared by Ana Rodrigues from the OECD Competition Division.

<sup>2</sup> See OECD Council’s Recommendation (17 July 2012) and OECD 2009 Guidelines on Fighting Bid Rigging in Public Procurement and the OECD Roundtables on Public Procurement (2007), Competition in Bidding Markets (2006) and Concessions (2006).

<sup>3</sup> See the Issues Note, DAF/COMP/WP2(2014)15 prepared for the Hearing on Auctions and Tenders, as well as the summary of discussion of the hearing held on December 15, 2014.

5. The two topics have little conceptual overlap, which makes their mix within the same note or discussion at first sight not very aesthetically appealing. Yet both have emerged as two important practical issues in public procurement systems. They both can have an impact on how competition takes place “*within the tender*” as well as “*in the market*”, thus affecting the level of efficiency of the auction with respect to a number of dimensions.

6. The absence of commonly established best practices with respect to both topics further adds relevance to their discussion. It is of the essence to better understand these two aspects, and discuss how the fair concerns that originated them can be effectively dealt with in procurement systems.

7. For the purpose of the discussion it is first important to know how different jurisdictions have experienced these concerns as well as the different approaches used to deal with them. With that aim, a survey was conducted among 56 jurisdictions to gather information on the relevant legal provisions and enforcement practices in their procurement systems. Furthermore, and following up on the discussion concerning tender awarding criteria and scoring rules previously held<sup>4</sup>, information was collected on the jurisdictions’ approaches to these issues.

8. The answers received thus provide a broad overview on the different alternatives used to address the two topics. The following are the survey’s key takeaways concerning the procurement systems of the jurisdictions which have responded:

- while differences exist across jurisdictions, most procurement systems allow for criteria which account for a price-only assessment and one which integrates both price and non-price attributes (hereafter, hybrid criteria);
- some jurisdictions state a preference for some type of criteria overall (i.e., irrespective of the products or services involved) or as a function of the nature of the goods and services to be provided;
- The choice of awarding criteria, non-price attributes and the corresponding weights on these as well as price are, to a large extent, to the discretion of the contracting authority. However, some limitations can exist;
- cost overruns and renegotiations are a concern for most jurisdictions;
- procurement systems of almost all the jurisdictions surveyed include a concept of ALT and related provisions, and some report difficulties in their implementation;
- in general, ALT related provisions do not allow for automatic exclusion of bids before the tenderer is given an opportunity to justify the offer submitted, but there are exceptions;
- frequently, the distance between the potential ALT’s price and i) government estimates for the contract’s costs or ii) a statistic of the prices of the bids submitted in the tender plays a role in the assessment of ALTs;
- average bidding methods are not used by the jurisdictions surveyed, but there are a few exceptions. The precise extent in which they are applied in the jurisdictions which allow them could not however be assessed from the answers received;

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<sup>4</sup> *Ibidem.*

- Some jurisdictions report difficulties in implementing ALT-related provisions and question their ability to identify and exclude problematic bids;
- partitioning contracts into lots is either allowed or promoted in most of the jurisdictions surveyed illustrating, *inter alia*, the increasing relevance of public procurement as a strategic tool for promoting other goals;
- the decision on the number and (relative) size of lots, as well as the auction format, is mostly at the discretion of contracting authorities;
- little guidance is available on how to optimally proceed to the division of a public procurement contract into lots.

9. The remainder of the note presents the survey results (Section 2) and develops a discussion on the different approaches to the two topics at stake, embedding the key takeaways from the survey (Section 3). Section 4 concludes with some policy considerations.

## 2. Survey

10. On April 1, 2015, a set of questions on tender rules were sent out to 56 jurisdictions and 27<sup>5</sup> of them have submitted an answer<sup>6</sup>.

11. The competition agencies invited to answer the questionnaire have, in some cases, collaborated with other national governmental agencies directly in charge of overseeing public procurement in their respective jurisdictions. In Italy, for example, that entailed the collaboration of the Anti-Corruption Agency (ANAC) and, in Canada, of the Ministry of Public Work and Government Services.

12. The questions sent out are included in an annex and covered several aspects, namely awarding criteria, frequency and extent of events such as cost overruns and re-negotiation, provisions and practices concerning ALTs as well as regarding partitioning public procurement contracts into lots.

13. On February 26, 2014, the EU issued Directive 2014/24/EU on public procurement (from here on the EU Directive on Public Procurement). EU Member States were provided with a transitional period, until 18 April 2016, to transpose the Directive. This Directive introduced the concept of ALTs and brought provisions which promote the division of contracts into lots. As a result, ongoing legal reforms with this regard are being carried out, in various stages, by the Czech Republic, Italy, Portugal, Slovakia and Sweden. Denmark has completed reforms on abnormally low tenders.

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<sup>5</sup> The following jurisdictions responded: Sweden, Czech Republic, Latvia, Romania, Italy, Denmark, Estonia, Bulgaria, EU, Germany, Spain, Switzerland, Slovakia, Hungary, Portugal, Ukraine, U.S., Canada, Australia, Israel, Brazil, Chinese Taipei, Costa Rica, Mexico, Japan, Colombia and Korea.

<sup>6</sup> In its submission, Australia notes that its federal system includes three levels of government, namely the national or “Australian Government”, state and territory governments and local governments. The Commonwealth Procurement Rules only apply to the national government, and each state or territory government sets its own procurement rules and also often stipulate requirements for local governments within their jurisdiction. The answer provided to the survey reflects only the policy and practices of the Australian Government. Switzerland emphasised that the procurement regulation has a federal and a state (canton) level where specific legislation is applicable. The answers describe the procurement system at the federal level.

## 2.1 *Criteria for Tender Award*

### 2.1.1 *Awarding criteria*

14. Almost all of the respondents to the survey have informed that both price-only and hybrid criteria (accounting for price and quality) are used in their jurisdictions, for awarding public procurement contracts. As a result, often an encompassing criterion is defined, which can be assessed either as price-only or entail a hybrid assessment (weighting price and non-price factors).

15. That is the case of the “Most Economically Advantageous Tender” (MEAT), as established in the EU Directive for Public Procurement. The MEAT is an overriding concept: as stated by the EU in the survey submission, it eliminates “*the traditional dichotomy of “lowest price” and “most economically advantageous tender” enshrined*” in the older Directive. The MEAT can be assessed on the basis of either price or cost effectiveness or using the “*best price-quality ratio*” which weights both price and non-price attributes.

16. Other examples of encompassing criteria are the “Best Value” used in the U.S. and Canada<sup>7</sup>, the “Most Advantageous Tender” criterion used in Brazil, the “Most Convenient Offer” in Costa Rica and the “Value for Money” used in Israel.

17. In some other jurisdictions, the definition of a MEAT is more restrictive, in the sense that it is defined as a hybrid criterion. Nonetheless, this more restrictively defined MEAT coexists side by side with the possibility of assessing tenders using a price-only criterion. These are thus mainly matters of terminology, while providing the same range of criteria for tender evaluation.

18. In Mexico, three awarding methods can be used, namely *Scoring “Non-price”* criteria, “*Cost-Benefit Analysis*” and “*Binary Evaluation*”. The first two account for quality aspects and the “*Binary Evaluation*” is a price-only criterion. In Japan, the “*Automatic Awarding Method*” in public procurement is a competitive tender awarded to the lowest price, and the “*Comprehensive evaluation method*” awards the tender to the bid whose price and other conditions are most advantageous for the government.

19. When both price-only and hybrid (mix of price and non-price) criteria are allowed, the choice of the most adequate for the tender at stake is usually left at the discretion of the contracting authority, as a function of the characteristics of the contract.

20. Price-only criteria are mostly used in projects where this is the only/main dimension which matters for the contracting authority, namely for more standardised works or services, or when specifications are very clear. Non-price criteria, on the other hand, are taken into account when the price dimension is insufficient to capture the contracting authorities’ preferences.

21. Yet, some jurisdictions state a preference for a certain criteria overall, i.e., for most public contracts, or as a function of the type of product or service involved in the tender. Figure 1 illustrates some examples.

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<sup>7</sup> The U.S. Federal Acquisition Regulation defines Best-Value as “*the expected outcome of an acquisition that, in the Government’s estimation, provides the greatest overall benefit in response to the requirement*”. In Canada, it is defined as a “*combination of price, technical merit, and quality (...)*”

Figure 1: Stated preferences for a given criteria

Price
<ul style="list-style-type: none"> <li>• <b>In Brazil</b>, non-price factors should be taken into account exclusively for predominantly intellectual services and may be used exceptionally in the procurement of large-scale works or services largely dependent on sophisticated or restricted technology. Furthermore, whenever non-price aspects are taken into account, price should be given a greater weight.</li> <li>• In <b>Costa Rica</b>, although both price and non-price attributes can be valued, price takes upon a preponderant role in choosing the winning bid, and has to be taken into account.</li> </ul>
Hybrid Criteria
<ul style="list-style-type: none"> <li>• According to the <b>EU Directive on Public Procurement</b>, Member States should restrict the use of the price-only criteria, so as to encourage greater quality orientation of public procurement. The Directive also allows Member States to prohibit the use of price or cost only criteria or restrict their use to certain categories of contracting entities or certain types of contracts.</li> <li>• <b>Estonia and Romania</b>, for example, referred to a preference for the MEAT, however noting that in practice, price-only is most often used.</li> </ul>
As a Function of Project Characteristics
<ul style="list-style-type: none"> <li>• In the <b>U.S.</b>, the Federal Acquisition Regulation states that cost or price may play a dominant role for acquisitions where <i>“the requirement is clearly definable and the risk of unsuccessful contract performance is minimal”</i>, and that <i>“the less definitive the requirement, the more development work required, or the greater the performance risk, the more technical or past performance considerations may play a dominant role”</i> in choosing the winning bid.</li> <li>• In <b>Ukraine</b>, the price-only criterion is to be used for goods and services which are not developed on a separate specification (a technical project), and for which an active market exists; non-price attributes are to be accounted for in complex or specialised procurement. In practice, however, price is the most used criterion and procurement entities rarely include criterion other than price.</li> <li>• In <b>Chinese Taipei</b>, construction works, property and services with different qualities are considered not suitable for a price-only assessment.</li> <li>• In <b>Mexico</b>, accounting for non-price attributes is mandatory for infrastructure work and preferable for public works. For standardised goods and services, price should be the main factor in awarding the contract.</li> <li>• In <b>Korea</b>, when the value of the goods or services being procured is <i>“less than 200 million Korean won or are simple commercial items”</i>, the price-only criterion is to be used. However, in most of the tenders, the contracting authorities take into account non-price attributes as well.</li> <li>• In <b>Portugal</b>, a price-only criterion can only be used when technical specifications are fully clear and set out in the call for tenders.</li> <li>• In <b>Switzerland</b>, the Federal legislation states that for the acquisition of largely standardized goods or services, the tender may be awarded according to a price-only criterion.</li> </ul>

### 2.1.2 *Non-price attributes specification and weighting*

22. The choice of the non-price attributes is mainly left to the discretion of the contracting authority, and the criteria are to be included in the bid notice. These mainly relate to the products and services of the contract, with respondents providing non-exhaustive lists of potential aspects to be included, such as quality of works and services, technical performance, aesthetic and functional characteristics, after-sales service and technical assistance, accessibility of spare parts, quality of the staff employed and delivery date, among others.

23. Some respondents referred to attributes of a different nature. For example, bidders' past performance in supplying the goods or services and their financial status are mentioned by Korea, and along similar lines, Canada refers to "competences" related to, for example, managerial structure, key personnel, prior industrial experience, facilities and financial strength. In Slovakia, however, requirements related to the financial and economic status and the technical or professional capability of the tenderer cannot be the criteria for awarding the tender, unless otherwise stipulated by law.

24. Frequently, social or environmental aspects are included in the list of attributes which can be accounted for. In the EU Directive on Public Procurement, the "*best price-quality ratio*" can encompass attributes related to compliance with certain environmental or social standards<sup>8</sup>. In Mexico, the "*Cost-Benefit Analysis*" criterion takes into account the percentage of handicapped workers employed. In Hungary, the extent of the employment offered to unemployed people can be weighted.

25. In all jurisdictions surveyed, contracting authorities are required to specify the relative importance of each criteria, namely through weights/metrics for each attribute, which can be stated in the form of scoring rules. In Spain, the law stipulates that prominent relevance should be given to criteria which can be translated into figures or percentages, obtained through the application of formulas included in the tender specifications. Often, weights can be specified by providing a range with a maximum spread (e.g., Sweden, Spain, Bulgaria, Slovakia and Hungary). Some procurement systems accommodate the challenges of weight specification by allowing for a descent ranking of the criteria whenever it not possible to specify weights (e.g., EU, Sweden, Spain, Bulgaria and Czech Republic).

26. The decision on the weights to be given to the different criteria is mostly at the discretion of the contracting authorities.

27. However, in Switzerland the case law has stipulated that price should be given a weight of at least 20% in the scoring rule; in Ukraine, the relative weight of the price in the scoring rule cannot be lower than 50%; and in Brazil and Cost Rica, price should be given a greater weight. In the Korean procurement system, there are guidelines for the specific weights to be attributed to the different attributes (Table 1):

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<sup>8</sup> The EC issued guidelines on environmental criteria – "*Buying green! A Handbook on Green Public Procurement*" (2011) and on accounting for social aspects – "*Buying social! A Guide to Taking Account of Social Considerations in Public Procurement*" (2010).

**Table 1. Korean Public Procurement Service's Assessment Standard**

	Awarding criteria				
	Price Attribute	Total	Non-price attribute		
			Procurement performance	Technological capability	Business Performance
Value > 1 bn won	55%	45%	5%	10%	30%
Value > 1 bn won	70%	30%	-	-	30%

28. Several jurisdictions have guidance for determining awarding criteria and weights when non-price attributes are used (e.g., Canada, Israel, Chinese Taipei, Italy, Estonia, Bulgaria, Latvia, Sweden, Hungary, Czech Republic, Mexico and Brazil):

- in **Canada**, information on weighting price and non-price attributes are set out in the *Public Works and Government Services Canada Supply Manual* and the *Procurement Information Nuggets*. Furthermore, the *Basic Guide for Bid Evaluation* provides detailed practical guidance on bid evaluation criteria and rating systems, contractor selection methods, bid scoring methods and bid evaluation procedures.
- **Israel's** administrative code guides the choice of scoring rules, reviewing the main properties of a set of scoring rules and identifying the circumstances in which some scoring rules are likely to work better than others;
- in **Chinese Taipei**, the procurement authority issued a number of practical guidelines for assessing the Most Advantageous Tender<sup>9</sup>;
- in **Italy**, guidance is provided for using the MEAT within project financing, acquisition of works, acquisition of supplies or services and for architecture and engineering services<sup>10</sup>;
- in **Estonia**, where preference is given to the MEAT, guidance on the application of this criteria was provided by the Ministry of Finance, following a survey conducted in 2013 to gather best-practices on the matter;
- in **Bulgaria**, the Public Procurement Agency published, in its website, practical guidelines for the assessment of bids according to the MEAT;

<sup>9</sup> Namely, the "(1) *Guidelines of Determining the Lowest Tender in the Procurement of Different Quality Subjects* (2) *The Guidelines of Determining the Most Advantageous Tender in the Procurement of Different Quality Subjects* (3) *The Operating Manual of the Most Advantageous Tender*; (4) *The Sample Documents for Signing and Managing by Agencies Handling the Most Advantageous Tender Projects*; and (5) *The Examples of Evaluation Items and Weight for Information Services*".

<sup>10</sup> *Determinazione n. 5 del 08/10/2008 - Determinazione n. 4 del 20/05/2009 - Linee guida per l'utilizzo del criterio dell'offerta economicamente più vantaggiosa nelle procedure previste dall'articolo 153 del Codice dei contratti pubblici [project financing]; Utilizzo del criterio dell'offerta economicamente più vantaggiosa negli appalti di lavori pubblici [acquisition of works]; Determinazione n. 7 del 24/11/2011 - Linee guida per l'applicazione dell'offerta economicamente più vantaggiosa nell'ambito dei contratti di servizi e furniture [acquisition of supplies od services]; Determinazione n. 4 del 25/02/2015 - Linee guida per l'affidamento dei servizi attinenti all'architettura e all'ingegneria [architecture and engineering services].*

- in **Latvia**, guidelines for assessing bids when the criterion is the MEAT also exist;
- in **Sweden**, in 2010, guidelines were issued focusing on the award of products and services contracts as well as works contracts, addressing the choice and use of awarding criteria<sup>11</sup>;
- in **Hungary**, the Public Procurement Authority prepares recommendations regarding the assessment methods for a tender award<sup>12</sup>.
- in **Czech Republic**, the Ministry of Regional Development issued guidelines describing the possibilities of assigning points to partial evaluation criteria while using the MEAT;
- in **Mexico**, there are practical guidelines for contracting authorities such as the Official Guidelines issued by the Ministry of Public Administration;
- in **Brazil**, the Federal Court of Auditors regularly publishes guidelines to be available for the federal, state and municipal levels of administration.

## 2.2 *Abnormally Low Tenders*

### 2.2.1 *Cost overruns*

29. Concerns with cost overruns and contract default are the main drivers that have led to the emergence of the legal provisions and case law on ALTs.

30. The answers collected illustrate a limited availability of surveys, reports or statistics which could allow a deeper characterisation of the extent of cost overruns.

31. Nonetheless, concerns with cost overruns were expressed by a number of jurisdictions, with some highlighting their particular incidence in large construction works (e.g., Germany, Brazil, Colombia, Sweden and Estonia). In Germany, for example, the perception that cost overruns are a serious problem led the German government to establish an expert group for the analysis of cost overruns and potential solutions, the results of which are expected for the end of 2015.

32. Some respondents have provided some figures which help illustrating the magnitude of the problem. Italy, for example, indicates that cost overruns occur in at least one fourth of public procurement tenders involving expenditures over 150,000 Euros.

Inaccurate planning, excessive tendering rebates, ex-post amendments, project delays, additional works and unforeseen circumstances are among the reasons for cost overruns mentioned in the survey answers.

33. The Italian submission notes that the scrutiny of ALTs “*does not appear to be sufficient to prevent excessive rebates and consequent attempts by the bidder to recoup costs eventually during the*

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<sup>11</sup> These guides are available, in Swedish, at the following link:  
<http://www.kkv.se/globalassets/publikationer/kammarkollegiet/vagledning/anbudsutvardering-vid-offentlig-upphandling-av-varor-och-tjanster-2010-9.pdf>.

<sup>12</sup> The guideline is available in Hungarian on the website of the Public Procurement Authority:  
[http://kozbeszerzes.hu/adatbazis/mutat/tajekoztato/portal\\_316329/](http://kozbeszerzes.hu/adatbazis/mutat/tajekoztato/portal_316329/)

*execution phase*". Some respondents refer to the relevance of accounting for non-price attributes in awarding the tender, at least in some types of contracts, to reduce the likelihood of cost overruns (e.g., Italy and Mexico).

### 2.2.2 *ALT concept in Procurement Systems*

34. Almost all the respondents to the survey (24 out of 27) have the concept of Abnormally Low Tender, or one which is analogous, in their procurement law<sup>13</sup>.

35. The three jurisdictions which have stated that their procurement law does not envisage ALTs or an analogous concept were Australia, Italy and Ukraine. However, in Italy the concept has emerged in the procurement case law<sup>14</sup> and in Australia, if an ALT is received by the officers evaluating a tender, the risks of awarding that bid would be considered as part of the value for money assessment. In Ukraine, the Antimonopoly Committee nonetheless receives complaints from bidders whose bids were excluded from tenders by procuring agencies on the grounds that they offered a very low price.

36. While such a strikingly high share of respondents has a concept of ALT, in the answers collected, no clear definition is provided for this concept, let alone a common one.

37. The EU Directive on Public Procurement does not define ALTs but refers that "*tenders that appear abnormally low in relation to the works, supplies or services might be based on technically, economically or legally unsound assumptions or practices*".

38. Legal provisions in Canada refer to "*a bid price which is not consistent with historical norms or the majority of the bids received*". In Chinese Taipei, ALTs are said to be those whose "*offered price is so low that it evidently appears to be unreasonable, and the quality of performance is likely to be impaired or the contract is not likely to be performed in good faith, or there are any other extraordinary situations*".

39. In Japan, the standard price for ALT review is defined as the "*standards for determining whether it is likely that the person who should be the counterparty to a contract will not satisfactorily perform the terms of the contract for the price that the person has offered*".

40. In Costa Rica, "Ruinous or non-remunerative offers" are defined as those whose price do not enable the fulfilment of the contractual obligations, being insufficient to cover total costs, such that there is a presumption that default will eventually take place.

### 2.2.3 *Approaches to the identification of ALTs*

41. When automatic exclusion is not allowed, the procedure of contracting authorities (denoted as CAs in Figure 2) on identifying and dealing with ALTs can be generally described as follows.

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<sup>13</sup> Sometimes these are referred to as "Unusually low price bids" (Canada), "Bids with artificially low value" (e.g., Colombia), "Offers with abnormal or disproportionate values" (e.g., Spain), "Unenforceable proposals" (e.g., Brazil) or "Ruinous or non-remunerative offers" (e.g., Costa Rica).

<sup>14</sup> Namely in some decisions of the Italian Anti-Corruption Authority (ANAC) decisions, including *Determinazione n. 6 of 8/7/2009 - Il procedimento di verifica delle offerte anormalmente basse con particolare riferimento al criterio del prezzo più basso*.

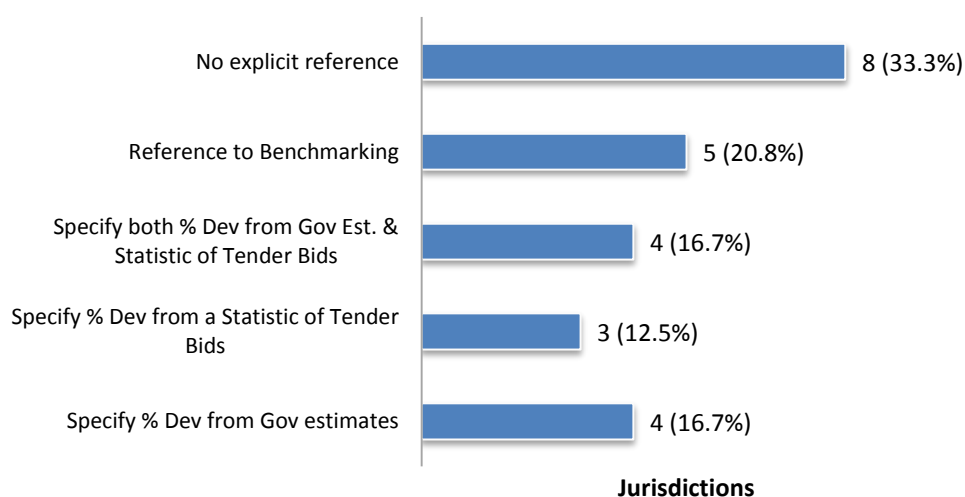
**Figure 2: Identification, assessment and potential rejection of ALTs**



42. According to the responses received, contracting authorities’ identification of a potential ALT may be due to the bid price appearing low with respect to estimates established by the government for the contract’s costs, the amount budgeted for the contract or some statistics of the prices of the all (or other) bids submitted to the tender.

43. The positioning of the bid’s price with respect to these thresholds can be such as to trigger further analysis of the bid’s conditions, or determine the automatic exclusion from the tender (although the latter is rarely envisaged) (see Figure 3).

**Figure 3: Role of benchmarking with respect to government estimates and a measure of the prices of bids submitted to the tender**



44. Table 2 provides details for the jurisdictions which pre-stipulate percentage deviations from government estimates.

**Table 2. Cases with pre-specified percentage deviations from government estimates**

Country	Benchmark Rules
Chinese Taipei	<ul style="list-style-type: none"> <li>• &lt;80% of the government estimate or,</li> <li>• if no government estimate is set: <ul style="list-style-type: none"> <li>▪ an evaluation panel or committee will determine whether the bid price is unreasonably low or</li> <li>▪ if the price is below 70% of the budgeted amount.</li> </ul> </li> </ul>
Portugal	<ul style="list-style-type: none"> <li>• Lower than the budgeted price set by the government by: <ul style="list-style-type: none"> <li>▪ 40% or more, in the case of public works contracts; or</li> <li>▪ 50% or more, in the case of other types of contracts.<sup>15</sup></li> </ul> </li> </ul>
Japan	For construction contracts, the standard for assessing whether a bid is an ALT is obtained by “multiplying the planned price by 0.7 ~ 0.9”.
Hungary	In the assessment of an individual element of the bid, a deviation by more than 20% from the estimated value for that given element.

45. In the case of Italy, Mexico and Bulgaria, pre-determined percentage deviations from a statistic of the price of the bids in the tender are used in assessing ALTs. Interesting concepts such as “*anomaly thresholds*” (Italy), or a “*convenient price*” (Mexico), are used, although not conceptually defined, to serve as a benchmark for assessing ALTs. Table 3 illustrates these cases.

**Table 3. Cases with pre-specified percentage deviations from the prices of bids in the tender**

Country	Benchmark Rules
Italy <sup>16</sup>	<ul style="list-style-type: none"> <li>• In price-only procurement procedures where at least five bids are submitted, the “<i>anomaly threshold</i>” is set with reference to “<i>the average of the percentage rebates of all eligible bids</i>”.</li> <li>• In tenders where the MEAT is used, “the anomaly threshold” is exceeded if the bid is above 4/5 of the highest scoring.</li> </ul>
Mexico	<p>In price-only tenders, a “<i>convenient price</i>” can be calculated as the average of the prices of all the technically acceptable bids minus a percentage set by the contracting authority and:</p> <ul style="list-style-type: none"> <li>• the lowest price bid wins as long as it is higher than the <i>convenient price</i> and</li> <li>• bids whose price is below the <i>convenient price</i> may be discarded.</li> </ul>
Bulgaria	the price of the bid is 20% below the average price of the other bids, in procurement processes with more than three bids.

<sup>15</sup> However, contracting authorities may adopt a different percentage.

<sup>16</sup> As established in the case law.

46. Some other jurisdictions use a combination of pre-specified percentage deviations from both government estimates and a statistics of the price of all (or the other) bids in the tender. This is the case in Spain, Korea, Brazil and Slovakia. In Korea, a concept of “*standard price*”, given by a weighted average between the amount budgeted and the average bid, is used for benchmarking (Table 4 provides further details).

**Table 4. Cases with pre-specified percentage deviations from both government estimates and prices of bids in the tender**

Country	Benchmark Rules
Spain	<ul style="list-style-type: none"> <li>• Only one bid, if it is 25% below the base budget;</li> <li>• two bids, whichever is lower than the other by more than 20%;</li> <li>• three bids, if it is 10% lower than an average measure<sup>17</sup> of the all bids</li> <li>• four or more bids, if it is 10% lower than an average measure of all bids<sup>18</sup>.</li> </ul>
Brazil	<p>For price-only procurement procedures for construction works and engineering services, when the value of the bid is &lt;70% of the minimum between the:</p> <ul style="list-style-type: none"> <li>• the average of bid prices &gt;50% of the amount estimated by the administration</li> <li>• the amount estimated by the administration<sup>19</sup>.</li> </ul>
Korea	<p>Thresholds for automatic exclusion of ALTs are:</p> <ul style="list-style-type: none"> <li>• any bid whose price is below approximately 80%<sup>20,21</sup> of the budgeted amount.</li> <li>• a bid price &lt; budget amount × 0.7 + the average bid × 0.3, in some construction projects.<sup>22</sup></li> </ul>
Slovakia	<p>If at least three bids qualify for the tender, a bid value at least:</p> <ul style="list-style-type: none"> <li>• 30% lower than the average of the value of the other bids;</li> <li>• 15% lower than the bid with the 2<sup>nd</sup> lowest value together with,</li> <li>• 15% lower than the estimated value of the contract (if provided).</li> </ul>

47. While not explicitly specifying thresholds, some other respondents have mentioned that the deviation of a bid’s price from government estimates or from the prices of all (or the other) bids submitted to the tender can be taken into account in identifying an ALT and trigger a request for further information (Latvia, Czech Republic, Estonia and Switzerland). In Canada, an ALT may arise if bid price is “*not consistent with historical norms or the majority of the bids received*”.

<sup>17</sup> The average measure is computed excluding those bids that are 10% higher than the average of all submitted bids (i.e., excluding the higher end of the bids’ distribution).

<sup>18</sup> The average is computed as described in footnote 16. However, if the remaining number of bids is lower than three, the average shall be calculated with the three lowest ones.

<sup>19</sup> Additionally, the tenderer is asked to sign additional guarantees if submitting a bid <80% of the lowest value amongst items a) and b).

<sup>20</sup> This value can vary according to the contracting authority, the product at stake or the bid amount.

<sup>21</sup> As set out in the “*Price Floor Policy for Tender Award*”.

<sup>22</sup> As set out in the “*Review on Adequacy of Bidding Prices Policy*”.

#### 2.2.4 *Assessing whether a bid is an ALT*

48. According to most of the respondents, upon a suspicion of an ALT, the contracting authority may request information from or hold consultations with the bidder to assess whether there is a justification for the offer submitted. Sweden describes the aim of these provisions as “*to protect tenderers against more or less arbitrarily being excluded from a procurement procedure*”.

49. Some respondents detailed the type of investigation and information that may prove useful for assessing a possible ALT. For example:

- The EU Directive on Public Procurement lists the aspects in which contracting authorities can focus their information requests, namely the “*1) economics of the manufacturing process, of the services provided or of the construction method; 2) technical advantages or any other favourable conditions enjoyed by the economic operator; 3) originality of the work, supplies or services; 4) compliance with obligations in the fields of environmental, social and labour law and with the rules on subcontracting; 5) obtainment of illegal state aid by the tenderer*”.
- Romania specifies that the contracting authority can check documents related, e.g., to the bidder’s prices, the situation of raw materials, the salaries of the workforce, the organization and methods used for delivering the contract as well as the performance and costs of tools and work equipment.
- In Canada, a consultation was undertaken to assess the practice on ALTs of the Government of Canada Procurement, which identified contacting suppliers to confirm the validity of ALTs as one of the internal practices adopted. Furthermore, guidelines exist which detail some of the actions that contracting authorities can undertake to assess a potential ALT.

50. According to the EU Directive on Public Procurement, in the case of ALTs which are due the bidder receiving state aid, the bidder should be provided with an opportunity to explain whether the state aid is in line with EU rules, and the European Commission must be informed if the bid is finally rejected on the grounds of state aid non-compatible with EU rules.

51. Some jurisdictions account for social or environmental considerations in classifying an ALT. In Brazil, the law stipulates that tenders incompatible with market wages shall not be admitted<sup>23</sup>. The EU Directive on Public Procurement states that contracting authorities should reject any ALT that results from non-compliance with environmental, social and labour law obligations. In Spain, the protection of labour conditions is also mentioned in the legal provision on ALTs. Sweden refers to the “*lack of payment of social security contributions and/or taxes*” as an important source of ALTs.

#### 2.2.5 *Rejection of an ALT*

52. Almost all the respondents do not allow for an automatic exclusion of a suspected ALT, rather they first provide the tenderer with an opportunity to justify the bid submitted within a specified period of time, to be assessed by the contracting authority. An offer can only be rejected if the bidder did not provide a sufficient explanation within the period of time specified.

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<sup>23</sup>

In some type of procurement services, namely for services which are labour intensive, concerns with ALTs due to un-compliance with labour laws seem particularly acute. Israel mentions that in tenders for cleaning, catering or security services, the government regulates wages and that therefore competition between the bidders takes place on other components.

53. Canada reports on a number of additional provisions to protect the integrity of the assessment procedure, as for example, those stipulating that the evaluation team cannot relax or otherwise change the evaluation criteria throughout the assessment, nor disclose information on the value of the second lowest bid.

54. From the answers provided, it is possible to verify that automatic exclusion of tenders can take place under the Korean procurement system, according to the thresholds specified in Table 4.

55. According to the Italian case law, a procurement agency may automatically exclude bids that exceed the “anomaly threshold” (see Table 3) in tenders for works whose value is below 1 million Euros, and in which more than ten bids were received.

#### 2.2.6 Average bidding methods

56. The majority of the jurisdictions have stated that average bidding methods are not used to choose the winning bid in their public procurement tenders. Several others referred that, while there are no specific provisions envisaging such methods, the awarding method which is more appropriate for the public procurement process at hand is established discretionarily by the contracting authority (e.g., Colombia, Israel, and Sweden). Colombia, for example, stated that average bidding methods are allowed to be used for these purposes.

57. In Canada, the choice of awarding methods and the approach to the identification and assessment of potential ALTs is at the discretion of the contracting authority. However, the Draft Report on *The Use of Zero Dollar Bid Practice in Government of Canada Procurement* found that the groups consulted employ a variety of internal practices in dealing with ALT, and that one of the most common strategies mentioned during consultations was the use of a “median bid scoring methodology”, particularly in professional service. Box 1 reports on the information provided by Canada.

#### Box 1. Average Bidding Methods in Canada

The implementation of the **median bid scoring methodology** referred by Canada is described as follows:

- “For the evaluation of each bid component, the values submitted are placed in numerical order.
- Then the median is determined. From this median, a range is chosen where bids will be considered acceptable by using factors such as past experiences, industry data, etc”.
- “Anything outside that range would be given the lowest possible score”.

An example on how this method is applied is provided in the Canadian answer:

- “IT Professional Services is evaluating a contract that has multiple bid components. For each component, they use a median evaluation strategy with a +30% and -20% range. They received 5 bids with the following value: 400, 250, 200, 0, 0. In this case, the median score is 200. The top part of the range becomes \$260 (\$200 x 30%) and the bottom range becomes \$160 (200 x (-20%)). Therefore, bids for this component will be anywhere from \$160 to \$260. Then, the scores are combined to reach an overall score”.

Another average bidding method used in Canada, for defence and major projects sector, is the “*Low Ball Penalty Process*”. It relates to the concept of “*Low Balling Strategy*” (detailed in Section 3), which consists in submitting low bids to win the tender, with the expectation to later renegotiate. According to the Draft Report, “*in order to maintain a level playing field*”, this method introduces a *Low Ball Penalty* to be applied to the score of bidders who offered prices below the average price of all compliant bidders.

Source: Answer from Canada, citing the Draft Report on the “The Use of Zero Dollar Bid Practice in Government of Canada Procurement”.

58. Finally, a note on Mexico, which although not using average bidding methods *per se*, describes a procedure where the benchmark with the price of all (or the other) bids in the tender has a role, not only on a potential rejection of an ALT, but also on the process of determining the winning bid. As detailed in Table 4, in tenders awarded with price-only criteria, the lowest price bid wins as long as it exceeds the *convenient price*, which is given by the average of the prices of all the technically acceptable bids minus a percentage set by the contracting authority.

### 2.2.7 *Renegotiation and the role of tender and contract design and monitoring*

59. The expectation of ex-post renegotiation can create incentives for bidders to strategically submit low bids, just to later renegotiate the contracted terms. However, proper tender and contract design, coupled with adequate subsequent monitoring of contract implementation, can play a central role in reducing the bidders' incentives for the adoption of this type of strategy.

60. The response by Sweden highlights the relevance of accurate design of the specifications, contract drafting and performance monitoring, with adequate resource allocation, in minimising problems with ALTs. Sweden mentions that clear delivery obligations and verifiable requirements, applying liquidated damages and placing reduced weight on price criteria can make it less attractive for bidders to compete with an ALT.

61. The U.S. response states that “*DOJ's [U.S. Department of Justice] economists have expressed concern about situations where a bidder bids low, even at a price generating a loss, knowing that it will be able to implement subsequent price increases, often in guise of unanticipated material cost increases and new design changes imposed by the purchasing entity*”. They classify this as a problem of optimal procurement, stating that the “*procurement rules should not allow the winner to “game” the process*”.

62. In terms of the frequency of renegotiation, the limited availability of data on the topic emerges from the survey answers. Colombia, however, reports some data provided by the national procurement agency<sup>24</sup> indicating that during 2014: 1.6% of the executed contracts had an amendment to increase value, 2.36% to extend its terms and 8.11% were amended with modifications on both.

63. Most jurisdictions foresee the possibility of modifying the contract (e.g., Brazil, Bulgaria, Czech Republic, Latvia, Estonia, Mexico, Korea and Spain), however with legal provisions limiting the scope and extent of the changes. “Major” or substantial changes to the contract (e.g., which surpass a given pre-specified percentage of the value of the initial contract, changing the economic balance or switching to other supplier) are often not allowed.

64. Renegotiations can generally take place due to exceptional or unforeseeable circumstances, namely, if the amendment can be justified by objective circumstances. Also, modifications foreseen in the contract in the form of review clauses can be accepted as a justification for modification in several jurisdictions (e.g., Spain, Sweden, Colombia, Portugal and Canada). Sweden characterises the scope for contract modification in its jurisdiction as very limited. Changes such as, for example, extension of time limits or of the scope of the contract are not allowed, unless accounted for in a clear, precise and unequivocal way in the initial contract.

65. In the EU, the Directive on Public Procurement introduced a general rule that contract modifications require a new tender procedure (see Box 2).

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<sup>24</sup> *Colombia Compra Eficiente*.

### Box 2. Modifications to Public Contracts under the 2014 EU Directive

Taking into account the relevant case law of the Court of Justice of the European Union, the EU Directive on Public Procurement stipulates that material changes to public contracts require launching a new public procurement procedure. This is particularly true for modifications of the scope and content of the mutual rights and obligations of the initial contract, and when the outcome of the initial procedure would have been affected if it had included the amended conditions. Such changes are seen as a demonstration of the parties' intention to renegotiate.

Nonetheless, the Directive acknowledges the need for some flexibility, relaxing this requirement for minor changes, as well as, under certain conditions, for situations in which contracting authorities are faced with the need for additional works, supplies or services or with unforeseen external changes. Art. 72 of the Directive specifies the range of situations circumstances in which the modifications may take place, namely:

- non-substantial changes or those which were envisaged in the initial procurement documents through clear and precise review clauses;
- modifications below 50% of the value of the initial contract:
  - in the face of unforeseen circumstances, and which do not change the overall nature of the contract, or
  - which have become necessary and a change of contractor is not possible for economic or technical reasons and would cause a substantial duplication of costs; and finally,
- where the original contractor is replaced as a consequence of an unequivocal review clause, universal or partial succession into the position of the initial contractor, or in the event that the contracting authority itself assumes the main contractor's obligations towards subcontractors.

The Directive defines unforeseen circumstances as those which could not have been predicted at the time of the initial contract, "*despite reasonably diligent preparation of the initial award by the contracting authority*"; and establishes a presumption of non-substantiality for changes which are below applicable thresholds; and that are lower than 10% of the initial contract value for service and supply contracts and below 15 % of the initial contract value for works contracts.

66. Finally, in Australia there are no legal provisions on renegotiation, and contract management is a responsibility of contracting authorities, under the overarching aim of the best value for money.

#### 2.2.8 *Securities and bonds*

67. Some jurisdictions have sought to identify ways of ensuring financial protection for the government (as well as for subcontractors), when faced by unfavourable events driven by ALTs.

68. For example, Canada's submission states that "*the few policy-driven provisions*" that exist concerning ALTs "*loosely outline courses of action in the processes of a) seeking clarification from the bidder of an abnormally low tender; and, b) obtaining financial protection for Canada in situations where there may be performance and delivery issues associated with an abnormally low tender*". Canada refers to "*holdbacks, security deposits and surety bonds*" as the "*principal traditional techniques*".

69. Other respondents, including Chinese Taipei and Brazil, have mentioned that tenderers may be asked to provide additional securities or guarantees in the case of a suspicion of an ALT.

### 2.2.9 *Practical challenges of different approaches for ALTs*

70. In what concerns experiences with the application of provisions on ALTs, practical challenges are mentioned by some of the respondents. Among these are the difficulty in identifying an ALT (Czech Republic), limitations in the applicability of ALT provisions (e.g., only when there is a given minimum number of bids in the tender) (Bulgaria) and difficulties in challenging bidders' explanations for the price bided (Estonia). Estonia states that it is almost impossible for contracting authorities to show that a contract cannot be performed under a given price, claiming that the bidder "*always gives some kind of explanation*" and that "*it is not possible for the contacting authority to show otherwise or verify the claims*". Estonia points out the absence of a practical solution for ALTs describing the related provisions as "*toothless*".

71. Korea mentions that, even though an assessment of the effects of ALT provisions in the country has not been systematically conducted, "*the provisions could have pushed up the procurement cost a little as a result of blocking relentless low bidders*". It also states that the provisions may have reduced the risk of contract default.

72. Costa Rica mentions a positive experience with ALT provisions in its jurisdiction, which are perceived as working well owing to the economic studies undertaken by the Administration of Costa Rica in the analysis stage. The procured is described as having allowed identifying ALTs and excluding them from the tender.

73. In Portugal, the legal framework stipulates that contracting authorities have to notify the Portuguese Competition Authority (PCA) of any exclusion of competitors due to ALTs. In its submission, the PCA mentions that in the approximately 40 notifications of ALTs it received and analysed, none regarded dominant firms in the markets at stake, nor was there evidence of a bid rigging cartel being involved. As such, the PCA never opened any investigation proceedings to further analyse potential predation strategies or bid rigging regarding these ALT cases.

74. Furthermore, the PCA expresses concerns with the possible chilling effect on more aggressive bids of ALT provisions, the risk of exclusion of more aggressive bids with a negative impact on the degree of competition within the tender, as well as the risk of bidders accessing information on their rivals costs, due to information disclosed for the purpose of justifying low prices<sup>25</sup>.

### 2.3 *Dividing contracts into lots*

75. The results of the survey show that the division of contracts into lots is currently a practice in the public procurement systems of most of the surveyed jurisdictions. They also show that the decision on how to split contracts into lots is, to a large extent, left to the contracting authorities and that little guidance exists on the matter.

76. Different procurement policies on the division of contracts into lots include:

- mandatory contract division (e.g., Brazil and Germany);
- promoting the division of contract into lots (e.g., EU, Israel, Italy and Japan);

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<sup>25</sup> Reporting on its experience in the private security market, Portugal states that there are cases where the bidders that are excluded from tenders due to ALTs are very small to medium-sized firms and that complainants are often firms with high market shares.

- allowing for that possibility without however explicitly encouraging its adoption (e.g., Estonia, Spain, Denmark, Canada and Mexico);
- not envisaging contract division (Korea); or
- limiting/prohibiting the method (e.g., Australia).

77. In Brazil, where dividing contracts into lots is mandatory, works, services and purchases procured are to be divided into as many parcels as technically and economically feasible provided that this does not impose any damage to the value of the contract to be bid, i.e., without loss of economies of scale. The provision thus generally addresses the trade-offs entailed by the procedure (see Section 3 for a discussion). In Germany, provisions specify that the mandatory requirement for contract division applies to sub-contracting as well.

78. In jurisdictions where splitting contracts into lots is promoted, provisions often stipulate that a decision by the contract authority of not to proceed with the division must be explained (e.g., EU, Romania and Italy). There may be legal provisions concerning specific types of projects, sectors or markets. For example, in Italy, the involvement of SMEs should be guaranteed in the case of tenders for large infrastructure projects.

79. In Mexico, however, it is the division of contracts into lots which must be justified with a market investigation that supports the procedure. The public tender call must also include a statement on the reasons why such measures do not limit access by interested participants.

80. A number of reasons were put forward by the respondents for the adoption of the procedure of dividing contracts into lots, namely the following (which sometimes interrelate):

- promoting SMEs and new entry;
- promoting tender participation, namely by special groups of firms (e.g., niche/specialised or local suppliers);
- fostering competition in the market;
- avoiding single supplier dependency; and
- risk spreading.

81. To achieve these aims, procurement systems where the division of contracts into lots is promoted sometimes allow for caps on the maximum number of lots that can be acquired by a single bidder (e.g., Switzerland, Israel and Italy) and “set asides” for groups of firms. In Israel, for example, tender committees are advised to use these caps for the number of lots acquired by larger bidders and at least reserve one lot for SMEs, to ensure they have a chance of being awarded a contract.

82. Several jurisdictions have highlighted the risk of contract splitting with the aim of circumventing the procurement procedural requirements applicable when certain thresholds for the value of the contract are exceeded (e.g., Canada, Latvia, and Chinese Taipei). This is often explicitly forbidden (e.g., Spain, Latvia, Romania, Czech Republic, Colombia and Chinese Taipei). The procedures to be applied can also be set with reference to the value of the initial contract or the value of the lots taken together (e.g., EU, Bulgaria, Latvia, Spain, Czech Republic and Sweden).

83. In what concerns the main criteria taken into account when deciding on the number and size of lots, detailed information was rarely provided. General principles emerge in several answers, namely the relevance of good market knowledge to allow the listed aims within the overarching principal of efficient procurement.

84. Several jurisdictions have mentioned some fundamental considerations as to the choice of the number and (relative) size of the lots to be tendered. These are assessed on a case-by-case analysis, very much related to the specificities of the market. Survey answers mentioned, for example, the number of players, technical and quality aspects, the speed of technological process, the functionality of each lot, the degree of information asymmetry, the risk of dependency on a sole supplier, among others. The Spanish Competition Authority (CNMC) considers that, in general, lots should be of different sizes so as to reduce the risk of collusive agreements. Mexico highlights that the division into lots may provide an unpredictability regarding timing and extent of consolation which may inhibit collusion and provide higher security of supply.

85. Colombia notes that segmentation of contracts into lots is often used for country-wide service provision, with the aim of enhancing competition and prompting participation by local providers. Some submissions describe patterns in their jurisdictions concerning the adoption of the practice within some specific sectors. For example, Sweden and Ukraine mention the segmentation of contracts into lots according to geographical areas and products (or product groups or baskets), in food procurement. In Germany, public contracts may either be divided into lots according to amounts or in terms of the works or services covered by contract. Several lots may be awarded in bundles, if that proves necessary for economic or technical reasons. The submission also informs that a software tool was developed to help calculating optimal lot sizes<sup>26</sup>.

86. Some submissions illustrate how the model chosen for dividing the contract into lots may negatively affect the tender outcome. Ukraine illustrates how the aim of increased tender participation can be jeopardise: the Anti-Monopoly Committee has received complaints of bidders concerning claims of unjustified association of unrelated products in one lot, reducing the range of participants in procurement procedures and potentially leading to the overvaluation of goods. Furthermore, not receiving offers for all the lots may entail a new procedure for the unbid lots, with the loss of the advantages of having a single tendering procedure (Colombia).

87. Procedural aspects vary. Box 3 illustrates, as an example, the rules applicable under the EU Directive on Public Procurement.

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<sup>26</sup> Made available by the Federal Ministry for Economic Affairs and Energy, together with the *Auftragsberatungsstellen Brandenburg und Hessen*.

### **Box 3. Splitting contracts into lots under the EU Directive on Public Procurement**

The EU Directive on Public Procurement provides incentives for contracting authorities to divide contracts into lots in public tenders. The ultimate goal is to enhance the participation of SMEs in public procurement within the EU (Recitals 78 and 79). As a result, although awarding a contract into separate lots is set as optional by the Directive, contracting authorities have to provide reasons whenever they decide not to do so. The Directive also provides that Member States may establish the awarding of a contract in the form of separate lots as mandatory within their respective territories [Article 46(4)].

Additionally, Article 46(2) allows contracting authorities to limit the number of lots that may awarded to one single tenderer, subject to the condition that the contract notice or invitation to confirm interest states the maximum number of lots per tenderer. It is also possible for authorities to specify, by the same means, that they reserve the possibility of awarding more than one lot to the same tenderer, as well as indicate the lots that may be combined [Article 46(3)]. In case the application of the award criteria would result in one tenderer being awarded more lots than the maximum number initially determined by the contracting authority, objective and non-discriminatory criteria or rules to be applied by the authority have to be indicated in the procurement documents.

Article 5 of the Directive determines the method for calculating the estimated value of procurement divided into lots. Each lot will be subject to the rules of the Directive in case their sum equals or surpasses the thresholds set forth in the Directive.

An exception to the application of the Directive [Article 5(10)] is made only in relation to lots with the estimated value net of VAT below 80,000 Euros for supplies or services, or 1 million Euros for works, under the condition that the aggregated value of the lots does not exceed 20% of the total value of the contract being divided.

### **3. A discussion on abnormally low tenders and partitioning contraction into lots**

#### **3.1 *Abnormally Low Tenders***

##### **3.1.1 *Reasons for lower bids***

88. Cost overruns, underperformance, contract default and delays in delivery time are a threat to the efficiency of procurement systems, entailing substantial welfare losses. These concerns drove efforts by governments and the public procurement community around the world to design mechanisms aimed at mitigating the extent of these problems. Legal provisions and case law on ALTs emerged as a result.

89. The widespread use of ALT related provisions is well illustrated by the results of the survey conducted. Their aim is to reduce the likely of unfavourable public procurement outcomes. However, it is important to devote thoughts to whether the outcome of applying these provisions is consistent with the aims they try to pursue.

90. This calls first for an exercise of reflection on the circumstances that may lead firms to place bids for public contracts which will entail a poor outcome for the government upon implementation of the contract.

91. As noted in a previous OECD Issues Note (OECD, 2014), one possible reason for such bids to occur is non-strategic, and follows from the bidder underestimating the costs associated with a public procurement contract (the well know problem of the “winner’s curse”<sup>27</sup> in the auction theory literature).

<sup>27</sup> The “winner’s curse” arises in common value auctions, (i.e., when access to competitors’ information or opinions influences a bidder’s own belief with regards to the value of the auctioned object). The winning bidder, when knowing he won the auction, realises his rivals valuations were lower and revises down his estimate of the object’s value (OECD, 2014).

This is thus an asymmetric information problem, and it is more prone to occur in the case of complex works and/or those which extend over a longer period of time. If the contract is awarded to a bid which underestimated the contract costs, the gap between the estimated costs and those in which the contractor will actually incur upon implementation of the contract will likely result, later on, in cost overruns, the contractor running into financial distress, decreased performance and quality, and calls for renegotiation.

92. Another reason for bids which entail unfavourable public procurement outcomes is strategic. It follows from bidders bidding too low to win the contract with an expectation of later being able to opportunistically renegotiate the terms – the so-called “*low-balling strategy*”. The Canadian submission to the survey describes this strategy as firms bidding low just to “*get their foot in the door*”.

93. Iimi (2013) analyses the impact of the expectations of renegotiation on firms bidding strategies and finds that bidders react strategically, namely by undercutting their bids. These strategies increase the likelihood of the contract being awarded, not to the most efficient bidder, but rather to the one which is more confident on its ability to renegotiate the terms. The U.S. submission expresses concerns with these strategies, also addressing the scenario where the higher “confidence to renegotiate” might be the result of an underlying fraud: “*the unusually low bid (for example, below an engineering estimate) may indicate fraud resulting from a payoff to a procurement official by the low bidder to get the contract, followed up later by work order changes that result in substantial increases in costs*”. A note here to bridge the current discussion to the crucial role of ensuring the integrity of public procurement procedures. The OECD has developed extensive work on this matter<sup>28</sup>.

94. The unrealistically low prices emerging from these two contexts – cost underestimation and strategic low bidding or “*low-balling strategy*” – raise serious concerns, entailing substantial distortions and leading to deviations from efficient tender outcomes. They, thus, need to be addressed in the pursuit of the overarching aim of public procurement efficiency.

95. While the two circumstances described above will, under certain conditions, lead to bids which are lower relative to the price of the other bids and government estimates, several circumstances might justify such low bids without however entailing poor public procurement outcomes. Indeed, firms’ costs and market strategies can exhibit a substantial degree of heterogeneity for various reasons. The following examples address some of them.

96. A bid may be substantially lower than other bids due to cost efficiencies (e.g., access to a superior technology or economies of scale and scope). If government cost estimates do not incorporate the cost efficiencies specific to that particular firm, in undertaking that particular contract, the price of the bid may also be lower than those estimates. For example, the lower bid may follow from complementarities between the product or services covered by the contract and other activities of the bidding firm. These complementarities may be specific to that firm and translate into lower bids for the contract.

97. The price of a bid which is lower than a measure of the prices of the other bids in the tender may also be the result of a competitive bid by a new entrant in a tender where there is a longstanding collusive arrangement among the other bidders. This may also translate into a deviation of the price of the bid from historical bidding patterns. The U.S. submission mentions that DOJ’s economists share concerns with this type of scenario: “*this pattern may be a red flag indicating past collusion*” and state that, in their outreach presentations, they encourage procurement officials to watch for this pattern.

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<sup>28</sup> For example, the OECD Recommendation on Enhancing Integrity in Public Procurement, adopted by the OECD Council in 2008 and the subsequent follow up on its implementation.

### 3.1.2 Addressing underestimation of costs and strategic low balling

#### *Approaches based on the identification and exclusion of ALTs*

98. If contracting authorities had perfect information about each bidder's costs, distinguishing between low bids driven by cost underestimation or *strategic low balling* and other situations which nonetheless do not entail poor outcomes would not be a problem. However, that is not usually the case.

99. As such, a first screen for ALTs taking into account the deviation from measures of the bids in the tender or government estimates would raise a flag in all the situations described above, yet they entail dramatically different outcomes. That raises questions concerning the impact, on procurement efficiency, of the automatic exclusion of bids based on benchmarking with other bidders' prices and government estimates.

100. As shown by the results of the survey, the most common approach to dealing with bids initially screened as potential ALTs consists in allowing the bidder to justify the price it offered or otherwise investigate possible reasons which could explain the bid. Many survey respondents have mentioned the need to assess other reasons which could justify the bid's price. The EU Directive, for example, mentions the "*economics of the manufacturing process, of the services provided or of the construction method; 2) technical advantages or any other favourable conditions enjoyed by the economic operator; [and] 3) originality of the work, supplies or services*".

101. The challenges to the exercise of identifying costs are, however, enormous, especially within a time frame which does not compromise the efficiency and timeliness of the public procurement procedure. Competition agencies, given the nature of their day-to-day activities, are particularly aware of the challenges of inferring firms' costs from information and documents provided for the purpose.

102. As such, there is a risk that competitive bids, which would bring about efficient outcomes upon implementation, are excluded from public procurement tenders. It is worth discussing this risk, as well as the potential extent of the increase in public procurement costs it may entail.

103. If this risk is low due to strict requirements upon contracting agencies to demonstrate that the bid would in fact entail poor outcomes due to unrealistic prices, then the risk is rather that of a low efficiency of the procedure in dealing with bids which are indeed problematic. The submission by Estonia expresses difficulties in implementing ALT provisions which are consistent with this scenario.

104. Additionally, and as the contribution from Portugal pointed out, the uncertainty concerning contracting authorities assessments can reduce the incentives to place competitive offers, particularly when substantial weight is given to ad-hoc statistical deviation measures from government estimates or the prices of all (or the other) bids in the tender.

105. Other attempts at addressing ALTs are the average bidding methods, whose origin can be traced back to the engineering literature (Ioannou and Leu 1993). According to these methods, the tender is awarded to the bid with the price closest to the average of the bids (or some other statistical measure of the tender bids). This may entail, for example, explicitly penalising bids which deviate from the average (see the example of the low balling penalties for relatively lower bid prices in Canada, described in Box 1).

106. However, there is no underlying economic theory to these methods, and they may entail deviations from the most efficient solution. Studies on the performance of these methods are very limited, and the outcome they entail is difficult to predict. A theoretical and empirical analysis carried out by Decarolis and Klein (2012) suggest that this methods may induce substantial gaming by firms, as bidders are expected to strategically adjust to the average bidding auction rules. Some papers have highlighted the potential for these methods to increase the risk of coordination, as bidders have incentives to submit

identical bids. For a discussion on the potential outcomes of these auctions and examples of some potential efficiency losses it can generate, see Albano et al, (2006).

*Approaches to eliminating the problem at the source: information issues and strategic bidding*

107. Methods for avoiding the costs associated with bids which entail unfavourable outcomes upon implementation of procurement contracts following cost underestimation and strategic underbidding may focus on preventing the conditions for such bids to emerge in the first place. However, the two problems differ in nature, and thereby need to be addressed in different ways.

108. The problem of cost underestimation relates to informational issues. Attempts at reducing the likelihood of cost underestimation involves addressing information asymmetries. For those purposes, the tender preparation stage is crucial. Detailed product specification, devoting efforts to accurate cost estimation and providing bidders with the relevant information can reduce uncertainty about costs. It is however crucial to avoid leakage of rivals' strategic information which could favour collusion. For contracts involving complex market information, the resource to independent advice could be beneficial.

109. Furthermore, it is important to provide bidders with adequate time for offer preparation, particularly in technically complex projects.

110. The issue of strategically low bidding is rather a commitment problem, related to the prospects of renegotiation of the contracted terms. The survey reveals the jurisdictions' awareness about the impact of renegotiation on procurement efficiency.

111. The topic of renegotiation was addressed in OECD (2014). Measures aimed at reducing contract incompleteness, increasing commitment with regards to the contracted terms and adopting a restrictive policy towards renegotiation can reduce the incentives for strategic low bidding. This calls for good tender and contract design, and efficiently monitoring subsequent contract implementation. Adequate pre-planning is a *sine-qua-non* condition for binding the contractor to the adequate project specifications. However, in complex contracts, it is also important to provide for the flexibility to deal with uncertainties which can only resolve upon the implementation of the contract. Appropriate monitoring promotes enforceability and reduces the scope for the contractor to decrease quality to recoup the losses associated with the lower contracted price.

112. OECD (2014) included a list of aspects which may contribute to tender and contract design aimed at reducing the risks associated with strategic underbidding, which are replicated here:

- adopting reasonable quality requirements and targets, otherwise lack of adjustment may trigger renegotiation later on;
- providing incentives for the contractor to complete the work in line with what was specified in the contract, such as penalties associated with failure to deliver. Their adequate pre-bidding disclosure can help discourage strategic bidding;
- spelling-out in detail, in the contract, the circumstances potentially leading to renegotiation;
- including clauses of no-renegotiation except in pre-determined eligible circumstances;
- allowing for the needed flexibility, including adjustments for unforeseen circumstances which may jeopardise the sustainability of the contracted terms, but specifying the terms of the revision (e.g., defining price review procedures in case of relevant unforeseen events);

- establishing guidelines for the renegotiation process in the contract;
- adopting a parsimonious attitude towards renegotiation requests and committing to the contractual rules for renegotiation - allowing for renegotiation only in pre-determined circumstances and for adjustments within the specified terms/guidance. This aims at building a “no-renegotiation” reputation.

### 3.2. *Partitioning Contracts into Lots*

113. Dividing public procurement contracts into lots can be used for pursuing several aims, such as promoting competition in the tender, promoting competition in the market, or for other strategic goals such as increasing SMEs’ participation in public procurement.

114. The promotion of SMEs has become a key socio-economic objective. Public procurement is increasingly being regarded as a strategic tool to pursue that objective. The survey conducted showed that dividing contracts into lots is promoted in many jurisdictions, or even mandatory in some (Germany and Brazil).

115. The discussion on the optimal division of a contract into lots is particularly challenging from a technical point of view. Solutions can only be designed on a case-by-case basis as they depend, to a large extent, on the specific characteristics of the market concerned and of the object of the contract. This is reflected in the survey results which show that the choice of the number and (relative) size of lots for partitioning a public procurement contract is left at the discretion of the contracting authorities.

116. The survey also illustrates the relevance of understanding how the market works. The exercise thus requires collecting, processing and synchronising a variety of clusters of market data. The systematisation and articulation of this “map of information”, on both product and geographical aspects, in a way which can translate into practical considerations as to the size and the number of lots is crucial for achieving an efficient outcome. Contracting authorities seek to assess the factors potentially relevant for the exercise of dividing the contract into lots.

117. There is, however, little guidance for contracting authorities, which likely follows from the challenges in providing guidelines on a method which very much needs to be tailored to the specificities of each case.

118. While a “*one size fits all*” solution cannot be prescribed, there is room for a fruitful discussion on potential comprehensive considerations. The economic theory literature on the subject is limited, but nonetheless provides several important insights<sup>29</sup>:

- The trade-off between potential competition gains and efficiency losses

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<sup>29</sup> See Grimm et al (2006) for an articulated review of the main contributions of the literature, oriented at extracting relevant practical considerations.

119. Efficiency losses can emerge if there are complementarities (e.g., economies of scale and scope) between different parts (lots) of the contract. If these complementarities are strong, firms will face uncertainty driven by the fact that they do not know which other lots they will win when placing their bid on a given lot. The internalisation of the risk of failing to win complementary objects and being unable to benefit from the resulting cost synergies will translate into lower valuations when placing the bids (the “exposure problem”<sup>30</sup>). Allowing bidders to place offers on bundles of lots, i.e., the possibility of package bidding<sup>31</sup> addresses this issue.

- The relevance of the number of firms in the market for choosing the number of lots

120. The ratio between the number of potential bidders and the number of lots has been shown to be another crucial consideration when deciding on the configuration of contract division. One of the key results of the literature states that having more lots than expected tender participants may deliver more competition for the lots and reduce the risk of collusive agreements (see Klemperer 2002 a). Important lessons can be learnt from the different outcomes of spectrum auctions in European countries; both for the ratio between tender participants and the number of lots as well as for the role of potential entrants in the market (see Klemperer 2002 b).

- The role of new entrants for the tender outcome

121. A further relevant aspect concerns the role of new entrants for the tender outcome. Promoting tender participation by new entrants is one of the keys in auction design (Klemperer a, Milgrom 2004). New entrants to the tender can introduce competition for the lots and weaken the conditions for collusion. When dividing contracts into lots, the relevance of new entrants is another relevant consideration. Whenever adequate, this may be addressed by reserving lots for entrants and/or impose caps on the number of lots that can be awarded to incumbents.

- The relative size of lots and the risk of collusion

122. Heterogeneity on the size of lots may play a role in reducing the scope for market sharing arrangements. For a discussion on the relevance for collusion of the relative size of lots as well as the auction format in the tender procedure, see Albano et al (2006).

123. A deeper discussion of these and other aspects which may provide relevant practical principles is of the essence, given the widespread increase of methods with a substantial impact on the efficiency of the tender outcome as well as on the structure of the markets for the goods and services involved in the contract.

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<sup>30</sup> See Klemperer (2002 a)

<sup>31</sup> Klemperer (2002) defines a package bid as “a single price offered for a set of items”.

#### **4. Conclusions**

124. The key takeaways of the survey conducted provide a broad overview of the different options for addressing two crucial challenges for procurement systems. The survey describes the experiences of the surveyed jurisdictions in implementing them. The sharing of experiences by the different jurisdictions provides important lessons and contributes to understanding the pitfalls, the benefits and the practical challenges of the different approaches.

125. The results thus set the grounds for a discussion on the merits of different approaches used to deal with bids that jeopardise efficient public procurement outcomes. Optimal policy choice to this regard may avoid self-fulfilling prophecies and contribute to public procurement efficiency.

126. However, maybe the most prominent result of the survey is that it shows that further guidance and insights on both topics are of the essence. The widespread use of both the ALT provisions and of the practice of dividing contracts into lots helps making the case for the need for further efforts. It calls for critically assessing current approaches, discussing scope for improvement, and providing further insights into the relevant considerations that may be accounted for by contracting authorities in the otherwise tailor made exercise of dividing contracts into lots.

127. Competition agencies can give an important contribution to this discussion.

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DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS  
 Competition Committee  
 Working Party No.2 on Competition and Regulation

The Chairman

COMP/ 2015.51

1 April 2015

**TO ALL COMPETITION DELEGATES AND PARTICIPANTS**  
**Re: Questionnaire on Specific Tender Rules**

Dear Delegate,

In the December 2014 meeting of Working Party 2, we held a hearing to discuss how the design of auctions and tenders can lead to efficient outcomes and providing winners with the incentives to deliver quality and to invest. We have also agreed to continue the discussion on optimal tender design in the June 19<sup>th</sup> meeting, this time discussing the so-called "abnormally low tenders", as well as best practices concerning the partitioning of public procurement contracts into lots.

Practices to exclude "abnormally low tenders" emerged because of Governments concerns of cost overruns and contract default following tender award. In June we would like to discuss the definition of "abnormally low tenders" that developed in procurement case law and whether it is indeed coherent with the objective it pursues or whether fairness considerations have also a relevant role.

In addition, public procurement is progressively being regarded as a strategic instrument to achieve other goals, such as promoting SMEs participation as well as increasing competition in the markets. Contract partitioning into lots is a primary tool for achieving these goals.

There is a vast scope for discussing best practices with regards to these two topics as well as their impact on competition and tender efficiency. The discussion in the June hearing will aim at contributing to the development of best practices on both.

The quality of this discussion can be greatly enhanced if we can gather information on the relevant legal provisions and enforcement practices in the procurement systems of different jurisdictions. Such information will allow us to identify the different approaches being used and drawing from jurisdictions experiences.

**With this purpose, we are asking you to answer to a short set of questions on your legal framework and experience on these issues.** Given the scope of the information requested, you might consider it useful to collaborate with the procurement agencies in your jurisdiction in preparing the answers. **The answers should be submitted to the Secretariat by 30 April 2015.**

All communications regarding this request for written contributions should be sent to Ana Rodrigues ([ana.rodrigues@oecd.org](mailto:ana.rodrigues@oecd.org), tel. +33 (0) 1 45249655), Cristiana Vitale ([cristiana.vitale@oecd.org](mailto:cristiana.vitale@oecd.org), tel. +33 (0) 1 45248530) and Angélique Servin ([angelique.servin@oecd.org](mailto:angelique.servin@oecd.org), tel. +33 (0)1 4524 1515).

With my best regards to all,

Alberto HEIMLER  
 Chairman, Working Party No.2 on Competition and Regulation

2, rue André-Pascal  
 75775 Paris Cedex 16, France

[www.oecd.org/da/comp/01/](http://www.oecd.org/da/comp/01/)

Tel.: +33 (0) 1 45 24 82 00



## QUESTIONS

1. Please describe the legal provisions in your jurisdiction concerning the awarding criteria in tenders, specifying whether and when do they only account for price and whether and when do they weight non-price criteria. Are any practical guidelines made available to contracting authorities?
2. If price and non-price attributes matter, what do the legal provisions stipulate for their assessment and how are they weighted in the awarding criteria? How is this done, in practice? Are any practical guidelines made available to contracting authorities?
3. To what extent is the problem of cost overruns in procurement projects frequent in your jurisdiction? Are these particularly of concern in certain types of projects (e.g., large construction works)? Have the underlying causes of such a phenomenon been analysed?
4. Does your procurement system include a concept of "Abnormally Low Tenders" (or any other similar concept)? If so, please define the concept utilized and describe the legal provisions stipulating how these offers should be identified/assessed and how they should be dealt with within the tender (e.g., are the bidders asked to provide justification for such offers?; are they automatically excluded from the tender? Fairness considerations play any role in the assessment of what is abnormally low? ).
5. There are families of awarding criteria, such as the average bid methods, which are sometimes used in an attempt to reduce the risk of abnormally low tenders. Does your jurisdiction foresee, or refrain from prohibiting, the use of such or similar award methods?
6. Could you please describe how the provisions related to abnormally low tenders have worked in practice and their impact in terms of procurement costs and the risk of cost overruns and default?
7. Please characterize the frequency of renegotiation of public procurement contracts in your jurisdiction. Are there explicit provisions to constraint ex-post renegotiation? If so, please provide a description.
8. Does your legal framework for procurement promote the division of contracts into lots? If so, please describe all the relevant provisions and the strategic aims pursued.
9. If applicable, please describe how the procurement agencies in your jurisdiction i) decide on how to partition contracts into lots (e.g., in terms of number and size of lots); ii) the main criteria and concerns they take into account in the division; and iii) the awarding method they use when there is contract partitioning. What are the main challenges experienced in your jurisdiction with these procedures?
10. If your jurisdiction is undergoing a revision of the relevant legal framework please describe the main directions of change with regards to the two central aspects covered by the questionnaire, namely i) "abnormally low tenders" and ii) dividing contracts into lots.
11. Excluding the bid rigging area, does your agency cooperate with contracting authorities to help them identify "abnormally low tenders" or the optimal size (and number) of lots? What has your experience been?