

Public Procurement and the EU Competition Rules

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of development in this field have clearly broadened its scope, not only to exert increasing pressure on the mechanisms of merger control and state aid, and to develop common tests and principles applicable in all of these main areas of competition law, but also (and more interestingly for the purposes of this study) to reach towards public restrictions of competition in neighbouring or frontier fields, such as the interplay between competition law and other types of economic regulation—eg, sectoral regulation in energy, telecommunications or other regulated markets¹⁰—or as regards intellectual property regulation.¹¹ Therefore, a modern conception of competition law can no longer be restricted to its ‘antitrust’ elements, or even limited to the rules contained in articles 101 to 109 TFEU and the rules on merger control, but should be conceived as *comprising all legal expressions of competition policy, broadly defined*.¹² In our view, under this broader approach to competition law, public procurement cannot be left apart or excluded from its field of application.¹³

Legal research conducted at the crossroads of competition and public procurement law can help gain a better understanding of both fields of regulation and practice, and can contribute to the development of *a more consistent system of EU economic law*. Moreover, adopting a wider perspective on competition and public procurement might provide a different view and shed some light on certain of the issues that each of these sets of regulation is still struggling to resolve. However, the relationship between both sets of economic regulation has so far been relatively under-explored.¹⁴ Therefore, *the time is ripe for a more detailed joint study of competition and public procurement*.

A. The Current Situation from a Competition Law Perspective

Given the strong political implications underlying public restrictions to competition—and, more generally, competition policy¹⁵—and the shortcomings that the basic rules and

¹⁰ See, eg: KJ Cseres, ‘What Has Competition Done for Consumers in Liberalised Markets?’ (2008) 4 *Competition Law Review* 77; and G Monti, ‘Managing the Intersection of Utilities Regulation and EC Competition Law’ (2008) 4 *Competition Law Review* 123.

¹¹ See, eg: V Korah, ‘The Interface between Intellectual Property Rights and Competition in Developed Countries’, (2005) 2 *SCRIPTed* 429.

¹² A clear example of such an expansion of the field of EU competition law is the inclusion of art 37 TFEU (ex art 31 TEC), or the inclusion under the concept of competition law of rules applicable to particular economic sectors, such as agriculture or transport; see A Jones and B Sufrin, *EC Competition Law: Text, Cases, and Materials*, 3rd edn (Oxford, Oxford University Press, 2008) 109–12. The adoption of a broad conception of competition law based on a concept of ‘*competition law in a wider sense*’ was the basis for a substantial reform and development of this field of regulation in Australia, particularly as regarded government-imposed impediments to competition; see A Fels, ‘Australia’s Comprehensive Review of Anticompetitive Laws’ in G Amato and LL Laudati (eds), *The Anticompetitive Impact of Regulation* (Cheltenham, Edward Elgar, 2001) 329, 332–33.

¹³ Along the same lines, see RD Anderson and WE Kovacic, ‘Competition Policy and International Trade Liberalisation: Essential Complements to Ensure Good Performance in Public Procurement Markets’ (2009) 18 *Public Procurement Law Review* 67, 69. Indeed, in the US, public procurement has been considered amongst other ‘regulated sectors’ and included within the field of application of competition law; see ABA, *Antitrust Law Developments* 3rd edn (Chicago, ABA Section of Antitrust Law, 1992) 1107–09; 4th edn (1997) 1251–56; 5th edn (2002) 1323–25; and 6th edn (2007) 1389–90.

¹⁴ As stressed in clear terms by C Munro, ‘Competition Law and Public Procurement: Two Sides of the Same Coin?’ (2006) 15 *Public Procurement Law Review* 352; and, previously, by S Arrowsmith, *The Law of Public and Utilities Procurement*, 2nd edn (London, Sweet and Maxwell, 2005) 62–72, 431–32 and 955.

¹⁵ DI Baker, ‘Antitrust and Politics at the Justice Department’ (1992–1993) 9 *Journal of Law and Politics* 291; and JB Baker, ‘Competition Policy as a Political Bargain’ (2006) 73 *Antitrust Law Journal* 483.

remedies of competition law present when trying to rein in the anti-competitive behaviour of the public sector, public restrictions to competition are amongst the sources of distortion of free market dynamics most pervasive, severe and difficult to combat. Yet, the fight against public restrictions of competition should be the main target of competition policy,¹⁶ as their suppression is a precondition for the development of effective and undistorted market competition.¹⁷ However, an effective competition policy against public restraints is still under-developed,¹⁸ and substantial improvement should not be expected unless strong political commitment is raised. Currently, competition policy is largely focused on the market behaviour of undertakings—and, these days, particularly on collusion and the fight against cartels—and neglects (or at least pays secondary attention to) market and non-market behaviour of the public sector.¹⁹

From a different perspective, competition policy is an economic policy of ‘offer’, as its main focus is not on consumption, but on the production and offer of goods and services. Hence, competition policy is focused on the market behaviour of producers, or offerors—including intermediaries and economic agents other than consumers. This characteristic of competition policy conditions its scope in a way that passes unnoticed. The object of the present analysis lies only—or mainly—in the offer (ie, production and distribution) of products and services and the ensuing market power that colluding and dominant firms can exercise. Other aspects of market competition receive relatively less consideration. However, the main focus of competition law should not be termed as the exercise of ‘market’ power, but as the exercise of ‘selling’ power. Such rephrasing automatically sheds light on a relatively unexplored field of competition law: the exercise of ‘buying’ power.²⁰ This is an omission that is not justified in economic terms, since competition law should treat seller power and buyer power alike.²¹ Arguably, then, development of the strands of competition policy focused on ‘buying’ power should be given high priority. However, competition policy is largely conceived of as a set of rules regulating sellers’ competition, whereas demand-side (or buyers’) competition policy remains largely under-developed.²²

¹⁶ Indeed, its importance can hardly be overstated; see OECD, *Report on Regulatory Reform: Synthesis* (1997) 33; and *ibid*, *Economic Policy Reforms—Going for Growth* (2009) 19 and 179–92.

¹⁷ H Demsetz, *The Organization of Economic Activity—Efficiency, Competition, and Policy* (New York, Basil Blackwell, 1989) 109, 206, 215 and 222–23.

¹⁸ MS Gal and I Faibish, ‘Six Principles for Limiting Government-Facilitated Restraints on Competition’ (2007) 44 *Common Market Law Review* 69, 70.

¹⁹ See: OECD, *Regulating Market Activities by the Public Sector* (2004) 7.

²⁰ See: JM Jacobson and GJ Dorman, ‘Joint Purchasing, Monopsony and Antitrust’ (1991) 36 *Antitrust Bulletin* 1. For a summary of recent trends in relation to the treatment of buyer power in competition law, and some insights into future developments, see BundesKartellamt, *Buyer Power in Competition Law—Status and Perspectives* (Working Group on Competition Law, Background Paper, 2008) available at www.bundeskartellamt.de/wEnglisch/download/pdf/2008_ProfTagung_E.pdf.

²¹ See: M Schwartz, *Should Antitrust Assess Buyer Market Power Differently than Seller Market Power?* (remarks presented at the DOJ/FTC Workshop on Merger Enforcement, 2004) available at www.usdoj.gov/atr/public/workshops/docs/202607.pdf. See also ER Elhauge, ‘Harvard, not Chicago: Which Antitrust School Drives US Supreme Court Decisions?’ (2007) 2 *Competition Policy International* 59, 69; and N Rosenfelt, ‘The Verdict on Monopsony’ (2008) 20 *Loyola Consumer Law Review* 402, 412. Contra, see JT Rosch, ‘Monopsony and the Meaning of “Consumer Welfare”: A Closer Look at Weyerhaeuser’ (2007) *Columbia Business Law Review* 353, 359–65. On these issues, see also E Pfister, ‘Buying Power and Competition Policy’ (2009) 1 *Conurrences* 34.

²² In general, for a preliminary approximation to the potential benefits of demand-side competition policies focused on reducing the costs of consumer choice (such as information or switching costs), see SF Ennis and A Heimler, *Promotion of Competition on the Demand Side* (SSRN Working Paper, 2004), available at ssrn.com/abstract=622722.

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The design and development of effective pro-competitive rules to discipline buying power are still incomplete.²³

Public procurement is at the intersection of the two relatively unexplored fields of competition law, as it relates to the *demand-side* market behaviour of the *public* sector.²⁴ Therefore, it should not be surprising to note that the enforcement of competition law in the public procurement environment has received much less attention than it deserves and, consequently, still remains largely underdeveloped.²⁵ To be sure, restrictions of competition generated by private entities participating in public procurement processes—mainly related to collusion and bid-rigging—have so far attracted most of the attention as regards the intersection of competition law and the public procurement phenomenon.²⁶ Similarly, some of the most remarkable issues at the juncture of EU state aid and public procurement law have already been addressed—such as whether the award of a public contract can constitute state aid, or under which conditions a recipient of state aid can participate in public tenders without this resulting in a breach of the principle of equality and non-discrimination.²⁷ A secondary focus has also centred on the impact of procurement markets in merger control cases, where the existence of a (public) power-buyer has usually been used by competition authorities as a blunt (but rather formal, and oftentimes

²³ In similar terms, see I Kokkoris, 'Buyer Power Assessment in Competition Law: A Boon or a Menace?' (2006) 29 *World Competition* 139. However, significant developments in this area have recently taken place in the US and could spur further developments in other jurisdictions; see US SCT opinion in *Weyerhaeuser Co v Ross-Simmons Hardwood Lumber Co*, 549 US 312 (2007). cf C Bovis, *EC Public Procurement: Case Law and Regulation* (Oxford, Oxford University Press, 2006) 42–49 and 600; and *ibid*, *EU Public Procurement Law* (Cheltenham, Edgar Elgar, 2007) 5–10, who considers that there is limited scope for the development of effective competition law mechanisms in the public procurement forum due to structural characteristics of 'public markets' (criticised below, ch 2).

²⁴ In fact, commentators that have focused on the interplay between public procurement and competition law have tended to stress such an 'offer-demand divide' between competition and public procurement law—see, eg PA Trepte, *Regulating Procurement. Understanding the Ends and Means of Public Procurement Regulation* (Oxford, Oxford University Press, 2004) 57; and, in more detail, *ibid*, *Public Procurement in the EU* (2007) 38–54. Similarly, C Bovis, 'The New Public Procurement Regime of the European Union: A Critical Analysis of Policy, Law and Jurisprudence' (2005) 5 *European Law Review* 607, 609; and *ibid*, *EC Public Procurement: Case Law and Regulation* (2006) 15–16 and 22–29. Whereas the separation between both sets of economic regulation is clear, this study attempts to go one step further and bridge some of the gaps generated by this 'offer-demand divide' by extending competition requirements to the demand side.

²⁵ To be sure, there are promising ways for the development of competition rules applicable to public sector activities that can have an impact on the markets; see eg, M Bazex, 'Le Droit public de la concurrence' (1998) 14 *Révue française de droit administratif* 781, 784; JY Chérot, 'Les méthodes du juge administratif dans le contentieux de la concurrence' (2000) 9 *Actualité juridique—Droit administratif* 687, 691–92; and S Nicinski, 'Les évolutions du droit administratif de la concurrence' (2004) 14 *Actualité juridique—Droit administratif* 751, 751–52.

²⁶ Indeed, this has been the main focus of international efforts, particularly by the OECD, which has recently published detailed guidelines to help design public procurement regulations to prevent collusion; see OECD, *Guidelines for Fighting Bid Rigging in Public Procurement. Helping Governments to Obtain Best Value for Money* (2009). See also the results of the various previous roundtables published by the OECD, 'Procurement Markets' (1999) 1 *OECD Journal of Competition Law and Policy* 83; *ibid*, *Competition Policy and Procurement Markets* (1999); *ibid*, *Competition in Bidding Markets* (2006); and *ibid*, *Public Procurement: The Role of Competition Authorities in Promoting Competition* (2007). This is also the focus of recent scholarly studies in this field; for instance, C Cabanes and B Neveu, *Droit de la concurrence dans les contrats publics. Pratiques anticoncurrentielles, abus de position dominante, controls et sanctions* (Paris, Le Moniteur, 2008); as well as some practitioners' guidance, see WE Kovacic, *The Antitrust Government Contracts Handbook* (Chicago, ABA Section of Antitrust Law, 1990).

²⁷ This issue is dealt with more extensively below ch 4, §II.A—where references are provided.

unwarranted) argument to adopt a relatively lenient approach.²⁸ However, in our view, private restrictions to competition, the impact of state aid, and the analysis of mergers in the public procurement setting do not present markedly differentiated trends when compared with similar restrictions that take place in any other markets.²⁹ Moreover, the few differences that can be identified stem chiefly from the peculiarities of public procurement regulations and the distortions that they generate in the market (or its analysis by competition authorities) and, consequently, can be better explained and corrected (if need be) through the competition analysis of public procurement regulations and administrative practices *themselves*.

However, this significant area of overlap between competition and public procurement law (ie, the competition distortions that public procurement regulations and administrative practices can produce themselves) still remains unexplored. *Generally, publicly-created distortions of competition in the field of public procurement have not yet been effectively tackled by either competition or public procurement law*—probably because of the major political and governance implications embedded in or surrounding public procurement activities, which make development and enforcement of competition law and policy in this area an even more complicated issue, and sometimes muddy the analysis and normative recommendations. Notwithstanding these relevant difficulties, in our view, this is a very relevant area of competition policy to which development could bring substantial improvements and, consequently, it merits more attention than it has traditionally received.

EU public procurement rules seem to be tilting towards a more flexible approach and towards conferring increased discretion to the public buyer.³⁰ This evolution is freeing the public buyer from the straightjacket that stricter public procurement rules used to impose on its market behaviour. Somehow, a paradoxical development of EU public procurement can be identified. While the new EU directives try to increase competition in the public procurement setting by freeing the public buyer from some restrictions that were considered to limit its ability to exploit market-like mechanisms in the procurement process, they also increase the discretion of the public buyer in running the system and try to leave room for increased administrative efficiency in public procurement. The paradox is that some of the rules that provide for an increased flexibility can also generate anti-competitive results. Consequently, the aims pursued by the EU directives on public procurement can be relatively inconsistent or hard to reconcile and, as a result, the effect on the aggregate efficiency of the system is unclear. In our view, some of these effects and unintended consequences could be avoided if a better understanding of the relationship

²⁸ See: PD Klemperer, 'Bidding Markets' (2007) 3 *Journal of Competition Law and Economics* 1; *ibid*, 'Competition Policy in Auctions and Bidding Markets' in P Buccirossi (ed), *Handbook of Antitrust Economics* (Cambridge, MIT Press, 2008) 583, 583 and 608–09; K T'Syen, 'Market Power in Bidding Markets: An Economic Overview' (2008) 31 *World Competition* 37 (2008); P Szilágyi, 'Bidding Markets and Competition Law in the European Union and the United Kingdom' (pts 1 and 2) (2008) 29 *European Competition Law Review* 16 and 89; and C Doyle, *The Countervailing Buyer Power Merger Defence* (London School of Economics and Political Science (LSE)—Department of Economics Working Paper, 5 February 2009), available at ssrn.com/abstract=1338322.

²⁹ Along these lines, OECD, *Public Procurement: Role of Competition Authorities* (2007) 7; and ABA, *Antitrust Law Developments* 5th edn (2002) 1322–23 and 6th edn (2007) 1389.

³⁰ S Treumer, 'The Discretionary Powers of Contracting Entities—Towards a Flexible Approach in the Recent Case Law of the Court of Justice?' (2006) 15 *Public Procurement Law Review* 71. See also Bovis (n 23) 199 and 602.

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between competition and public procurement was gained and their cross-implications were made explicit.

B. The Current Situation from a Public Procurement Law Perspective

For its part, the relevance of exploring and reflecting on competition issues in the framework of public procurement derives from the strong (and, more than probably, increasing) reliance of the public purchaser on the market in order to discharge a significant number of activities in the public interest.³¹ The effectiveness of public procurement and its ability to contribute to the proper and most efficient carrying on of public interest obligations is conditional upon the existence of competition in two respects or separate dimensions.³² One of them has been expressly recognised for a long time by public procurement regulations, which have tried to foster *competition within the specific tender*. Public procurement rules protect and promote competition—in this narrow sense—as a means to achieve value for money and to ensure the legitimacy of purchasing decisions. From this perspective, competition is seen as a means to allow the public purchaser to obtain the benefits of competitive pressure among (participating) bidders, as well as a key instrument to deter favouritism and other corrupt practices and deviations of power.

However, a subtler and stronger dependence of public procurement on *competition in the market* exists, but it is implicit and has generally been overlooked by most public procurement studies.³³ In order to attain value for money and to work as a proper tool for the public sector, public procurement activities need to take place in competitive markets.³⁴ Public procurement rules assume that markets are generally competitive—in the broad sense—or, more simply, take as a given their economic structure and competitive dynamics.³⁵ The existence of competitive intensity in the market is usually taken for

³¹ Indeed, the activities of the modern state as a buyer can hardly be overstated; see P Vincent-Jones, *The New Public Contracting. Regulation, Responsiveness, Relationality* (Oxford, Oxford University Press, 2006) 13–25, 167–99 and 347; and PC Light, ‘Outsourcing and the True Size of Government’ (2003–2004) 33 *Public Contract Law Journal* 311.

³² On the relationship between general interest and competition considerations in public procurement, see F Gartner, ‘Des rapports entre contrats administratifs et intérêt général’ (2006) 22 *Revue française de droit administratif* 19, 21.

³³ Exceptionally, as already indicated, the relevance of competition in the market (as protected by competition law) for the proper functioning is stressed by Trepte, *Regulating Procurement* (2004) 57, 61 and 122. It has been held that the notion of competition in the sphere of public procurement rules is different than the broader notion of competition that constitutes a fundamental principle of EU law, although close links between them must be acknowledged; see JF Brisson, *Les fondements juridiques du droit des marchés publics* (Paris, Imprimerie Nationale, 2004) 25; and O Black, *Conceptual Foundations of Antitrust* (Cambridge, Cambridge University Press, 2005) 9. However, as shall be seen, both concepts of competition are present in public procurement rules, and competition in the broader sense is also one of the fundamental principles of EU public procurement law. Therefore, the impact of public procurement on competition in the market should be stressed and will be of central importance in this study.

³⁴ See: SL Schooner, ‘Pondering the Decline of Federal Government Contract Litigation in the United States’ (1999) 8 *Public Procurement Law Review* 242, 248. Indeed, the case has been made convincingly by Anderson and Kovacic, *Competition and International Trade* (2009) 70–72. Similarly, stressing the importance of shielding public procurement from anti-competitive market practices, see DE Brunk, ‘Governmental Procurement: “FAR” from a Competitive Process’ in G Piga and KV Thai (eds) *Advancing Public Procurement: Practices, Innovation and Knowledge-Sharing* (Boca Raton, PrAcademics Press, 2006) 156.

³⁵ See: G Piga and KV Thai, ‘The Economics of Public Procurement: Preface’ (2006) *Rivista di Politica Economica* 3, 5; also, KV Thai, ‘Public Procurement Re-examined’ (2001) 1 *Journal of Public Procurement* 9, 34.

granted, or simply disregarded, in public procurement studies. In general terms, this approach is correct in that public procurement is not designed to prevent distortions of competition between undertakings. However, *issues regarding competition in the market are not alien to public procurement*,³⁶ and need to receive a stronger emphasis.³⁷

Public procurement rules can themselves generate significant distortions of competitive market dynamics³⁸—and, in so doing, can be largely self-defeating, as they can restrict the effective chances for the public buyer to obtain best value.³⁹ Public procurement regulations tend to establish a market-like mechanism that, in most instances, ends up isolating parts of the market—ie, creating ‘public (sub-)markets’—which become highly regulated (by public procurement rules themselves) in various aspects and that, in the end, can result in restrictions or distortions of competition that limit the ability of the public buyer to obtain value for money. Hence, in order to promote the efficiency of the procurement activities and value for money, public procurement rules need to be pro-competitive and guarantee that they do not restrict or distort competition in the market.⁴⁰

C. Overall Perspective

Putting the previous considerations together, in our view, the increasing interest of public procurement activities from a competition law perspective as an *object* to be integrated in its scope,⁴¹ and the evidence of the role of competition in the market as a *prerequisite* for the proper development of public procurement activities, are but a manifestation of the strong links between both sets of economic regulation.⁴² Where competition law fails to guarantee undistorted competition, public procurement will hardly develop optimally and the government’s alternatives will be significantly impaired by the distorted conditions under which it seeks to procure goods or services. Similarly, when public procurement

³⁶ Sauter and Schepel (n 5) 49.

³⁷ The idea is not new; see CW Sherrer, ‘Achieving a Higher and More Competitive State-of-the-Art in DOD Procurement Procedures’ (1982) 15 *National Contract Management Journal* 71, 76.

³⁸ A fact that was clearly stressed by DF Kettl, *Sharing Power. Public Governance and Private Markets* (Washington, Brookings Institution, 1993) 31. See also Anderson and Kovacic (n 13) 89–91; and G Amato, ‘Practical Economic Guidelines for Reforming Regulation to Eliminate its Anticompetitive Effects’ in *ibid* and LL Laudati (eds), *The Anticompetitive Impact of Regulation* (Cheltenham, Edward Elgar, 2001) 459.

³⁹ Indeed, the need to have ‘good legislation’ to foster the proper and competitive functioning of procurement markets has been stressed; see L Fiorentino, ‘Public Procurement and Competition’ in KV Thai et al (eds) *International Public Procurement Conference Proceedings* (2006) 847.

⁴⁰ Similarly, see L Fiorentino, ‘Conclusioni e proposte’ in *ibid* (ed) *Lo Stato compratore. L’acquisto di beni e servizi nelle pubbliche amministrazioni* (Bologna, Il Mulino, 2007) 325, 326; and JJ Snider Smith, ‘Competition and Transparency: What Works for Public Procurement Reform’ (2008) 38 *Public Contract Law Journal* 85, 110–11.

⁴¹ In this regard, see the various works by O Guézou, *Droit de la concurrence et Droit des marchés publics: vers une notion transversale de mise en libre concurrence* (2003) *Contrats publics—Actualité de la commande et des contrats publics* 43; *ibid*, ‘Droit des marchés publics et Droit de la concurrence’ in C Bréchon-Moulènes (ed), *Droit des marchés publics* (Paris, Le Moniteur, 2006) III-130; and ‘Champ d’action du Droit de la concurrence et marchés publics’ in C Bréchon-Moulènes (ed), *Droit des marchés publics* (Paris, Le Moniteur, 2006) III-133. Also E Berkani, ‘Competition Law and Public Procurement: An “Inventory of Fixtures”’ (2007) 1 *Concurrences* 58; and L Idot, ‘Commande publique et Droit de la concurrence: un autre regard’ (2008) 1 *Concurrences* 52.

⁴² On the complementarity of competition law and public procurement, see Anderson and Kovacic (n 13) 75–94; and RD Anderson and CR Yukins, *International Public Procurement Developments in 2008—Public Procurement in a World Economic Crisis* (George Washington University Law School, Legal Studies Research Paper No 458), available at ssrn.com/abstract=1356142.

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rules are not effectively pro-competitive, they can generate market failures that competition law is designed to minimise. In those cases, enforcement based on competition principles (ie, the design of more competition-oriented public procurement) becomes necessary if undistorted market competition is to be attained. Therefore, *the strong links between both sets of regulation claim for a common approach and for consistent application.*

II. General Approach to the Interrelationship between Competition and Public Procurement Law

A joint study of public procurement and competition law could be pursued from several different angles and focus on different aspects of the interrelationship between these two sets of economic regulation. The general approach adopted in this study towards the interrelationship between competition and public procurement law is grounded on two starting assumptions: that competition *goes first*, and that there is room for *more competition* in public procurement.

The emphasis on competition law considerations should be clear from the outset. Putting competition first is not random. The reader should be aware that, while being a study at the crossroads of competition law and public procurement and while trying to keep an open and balanced approach towards the consideration of specific elements of competition and public procurement simultaneously, the point of departure and, probably, of arrival might remain closer to the field of competition law—given that *competition is a general principle of EU (economic) law that must be taken into account in the design of all types of economic regulation.*⁴³ Hopefully, the study will succeed in demonstrating that competition is not alien to public procurement law and, consequently, that there is and always has been a natural place for competition considerations within the field of public procurement. In the end, in our view, competition is a fundamental principle that must be protected and furthered to the maximum possible extent within the field of public procurement.

It is also worth stressing the underlying conviction that public procurement is currently not as pro-competitive as it could (or ought to) be—or, put otherwise, that current public procurement rules and practices generate distortions in market competition dynamics—and, consequently, that there is room for significant improvement in this area. Therefore, the reader should be aware that the study is not completely neutral in that it not only adopts a positive approach towards the description of the current state of the law at the crossroads of public procurement and competition, but also aims at formulating normative recommendations that, in our view, could contribute to improving the current situation and developing a more pro-competitive public procurement system. Given the importance of differentiating between the positive and normative aspects of the

⁴³ All in all, *'freedom of competition stands as a general principle of EC law'*; see Case 240/83 *Waste oils* [1985] ECR 531 9. Similarly, see Case 249/85 *Albako* [1987] ECR 2345 16; Case C-126/97 *Eco Swiss* [1999] I-3055 36–37; and Case C-453/99 *Courage and Crehan* [2001] ECR I-6297 20–21. See also O Odudu, *The Boundaries of EC Competition Law: The Scope of Article 81* (Oxford, Oxford University Press, 2006) 9. Indeed, competition is one of the general principles of substantive EU law; T Tridimas, *The General Principles of EU Law*, 2nd edn (Oxford, Oxford University Press, 2006) 5.

research—as the former should be less controversial and more widely accepted than the latter—normative considerations will be identified as such. However, there is always scope for residual issues in which disentangling positive and normative analysis might be particularly difficult or subtle. In those cases, the opinions offered in the study might be tainted by the general purposive approach towards the construction of a more pro-competitive public procurement system. The reader might want to keep this remark in the back of her mind.

III. Aim of the Study

As mentioned in passing, and in broad terms, the object of the study is the interrelation between competition and public procurement law. More specifically, the inquiry will focus on whether competition law principles inform or condition public procurement rules and to what extent, as well as on whether existing competition and public procurement institutions generate the appropriate framework for the analysis and discipline of the purchasing activities of the public buyer—ie, whether they are adequate to ensure that competition is not distorted in markets where public procurement is particularly significant. Therefore, the main objective of the research will be to explore and analyse the possibilities for competition law enforcement in the sphere of public procurement—ie, for the establishment of more pro-competitive public procurement rules and practices⁴⁴—and to develop an analytical framework for the appraisal of the market behaviour of the public buyer from a competition perspective.⁴⁵

The basic research question that this study attempts to answer could be formulated in the following terms: *How can and should publicly-generated competitive distortions in the public procurement field be addressed under EU economic law and, particularly, under the general framework of competition and public procurement law?* The object of the study can therefore be considered a ‘macro-legal question’,⁴⁶ which will need to be broken down into a series of smaller issues that help structure the research and reach partial conclusions that add up to a final answer to this broad question. Breaking down the object of analysis into smaller pieces should put the focus on each of the multiple dimensions of the integration of public procurement and competition law, one at a time.

⁴⁴ The importance of developing more competition-oriented public procurement rules and practice was emphasised by the Conseil de la Concurrence, *Jurisprudence et avis de 2001—Collectivités publiques et concurrence* (2002) 328–9, at lesrapports.ladocumentationfrancaise.fr/BRP/024000128/0000.pdf.

⁴⁵ In general terms, this study can be conceived of as an attempt to contribute to market (or regulation) reform on the basis of two of its main primary measures; see SK Vogel, ‘Why Freer Markets Need More Rules’ in MK Landy et al (eds), *Creating Competitive Markets. The Politics of Regulatory Reform* (Washington, Brookings Institution Press, 2007) 25, 37.

⁴⁶ MM Siems, ‘Legal Originality’ (2008) 28 *Oxford Journal of Legal Studies* 147, 152–56.

V. Public Procurement as a Market Failure: Difficulties in Recreating a Competitive Scenario and Competition-Restricting Effects

After having explored several different dimensions of public procurement activities in previous sections, the enquiry now turns towards the analysis of the effects that the market behaviour of the public buyer can generate on competitive dynamics. Economic research in the public procurement area has largely been focused on ‘tender-specific’ aspects such as the option between auctions and alternative award methods (ie, direct negotiation),⁷¹ the optimal design of contracts, the proper design of remuneration schemes,⁷² the allocation of risks,⁷³ the generation of adequate incentives for bidders (both during the tendering phase and the implementation of the contracts),⁷⁴ the setting up of monitoring systems,⁷⁵ or the avoidance of undesired practices (such as collusion and corruption).⁷⁶

However, from an economic point of view, the competition facet of public procurement has been a largely neglected area of study.⁷⁷ This section aims to conduct a review of the more general economic analyses of buyer power and buyer-dominated markets and to apply them to public procurement. In order to do so, some preliminary issues should be

⁷¹ For reviews of the literature, see RM Stark and MH Rothkopf, ‘Competitive Bidding: A Comprehensive Bibliography’ (1979) 27 *Operations Research* 364; R Engelbrecht-Wiggans, ‘Auctions and Bidding Models: A Survey’ (1980) 26 *Management Science* 119; and PR Milgrom, ‘Auctions and Bidding: A Primer’ (1989) 3 *Journal of Economic Perspectives* 3. More recently, see P Bajari and S Tadelis, ‘Incentives versus Transaction Costs: A Theory of Procurement Contracts’ (2001) 32 *RAND Journal of Economics* 387; and JJ Horton, *Procurement, Incentives and Bargaining Friction: Evidence from Government Contracts* (Kennedy School of Government, Working Paper, 2008), available at ssrn.com/abstract=1094622; and P Bajari et al, ‘Auctions versus Negotiations in Procurement: An Empirical Analysis’ (2009) 25 *Journal of Law, Economics, and Organization* 372.

⁷² S Reichelstein and K Osband, ‘Incentives in Government Contracts’ (1984) 24 *Journal of Public Economics* 257; and S Reichelstein, ‘Constructing Incentive Schemes for Government Contracts: An Application of Agency Theory’ (1992) 67 *Accounting Review* 712.

⁷³ As an example and with references to other works, see T Kirat (ed), *Économie et droit du contrat administratif: L'allocation des risques dans les marchés publics et les délégations de service public* (Paris, Documentation Française, 2005). See also A Calveras et al, ‘Wild Bids. Gambling for Resurrection in Procurement Contracts’ (2004) 26 *Journal of Regulatory Economics* 41.

⁷⁴ General studies in this area include the very remarkable contributions of McAfee and McMillan (n 22); and JJ Laffont and J Tirole, *A Theory of Incentives in Procurement and Regulation* (Cambridge, MIT Press, 1993). For recent comprehensive studies, see also PD Klemperer, *Auctions: Theory and Practice* (Princeton, Princeton University Press, 2004); and PR Milgrom, *Putting Auction Theory to Work* (Cambridge, Cambridge University Press, 2004). For a recent non-technical survey of auction theory, see PD Klemperer, ‘Auction Theory’ in ABA, *Issues in Competition Law and Policy* (Chicago, ABA Section of Antitrust Law, 2008) 539. On more specific incentive-related issues, see S Dasgupta, ‘Competition for Procurement Contracts and Underinvestment’ (1990) 31 *International Economic Review* 841.

⁷⁵ See, eg: TL Brown and M Potoski, ‘Managing Contract Performance: A Transaction Cost Approach’ (2003) 22 *Journal of Policy Analysis and Management* 275.

⁷⁶ See the various studies in R Engelbrecht-Wiggans et al (eds), *Auctions, Bidding, and Contracting: Uses and Theory* (New York, NYU Press, 1983); AG Bower and JN Dertouzos (eds), *Essays in the Economics of Procurement* (Santa Monica, RAND—National Defense Research Institute, 1994); and G Piga and KV Thai (eds), *The Economics of Public Procurement* (Hampshire, Palgrave-Macmillan, 2007).

⁷⁷ In general, public procurement has received less attention than it merits from the academic economic community; see KV Thai, ‘Public Procurement Re-examined’ (2001) 1 *Journal of Public Procurement* 9, 10. See also OECD, ‘Procurement Markets’ (1999) 1 *OECD Journal of Competition Law and Policy* 83, 110. For an exception, see L Johnson, ‘Gains from a Unified European Community Public Procurement Market: An Analysis Using Auction Theory’ (1990) *Brigham Young University Law Review* 1727, 1729.

clarified, in order to set the proper context for the more specific analysis of the competitive effects generated by public procurement rules and practices.

In this regard, the fact that *public procurement regulations and practices are a source of market failure* has largely been omitted in economic studies in this field. The existence of a particular type of market failure (ie, externalities) has usually been used as a main economic argument in order to justify public provision of public goods (be it through direct governmental production or through public procurement).⁷⁸ However, a different type of market failure—ie, the effect of public procurement regulations themselves on the functioning of the markets where the public buyer sources all types of goods, services and works, and the impact that they can have on other agents—has received much less attention. This section will focus on this less explored aspect of the economic analysis of public procurement, which in our view bears direct and significant relevance to the development of a sound competition policy in this field.

Several aspects will be analysed. Firstly, public procurement will be analysed as a market-like regulatory instrument capable of generating market distortions (§V.A). Second, a model for the (partial or approximated) appraisal of such potential distortions will be briefly presented (§V.B)—and its basic insights will be used to frame the analysis of the potential competition distortions that can derive from public procurement. Finally, the three main types of competitive distortions that can derive from public procurement rules and practice will be explored: direct *waterbed effects* (§V.C), indirect *pro-collusive effects* (§V.D), and *other effects* (§V.E).

A. Public Procurement as a Market-Like Regulatory Instrument

It can hardly be overemphasised that public procurement is a mechanism of government economic intervention,⁷⁹ and that public procurement regulations and administrative practices can significantly alter the competitive structure of markets⁸⁰—particularly by

⁷⁸ See: McAfee and McMillan (n 22) 137–40; and Trepte (n 5) 9–11. Generally, on the treatment of public goods and the associated externalities, see T Cowen (ed), *The Theory of Market Failure. A Critical Examination* (Fairfax, George Mason Univ Print, 1988). See also JR Davies and JR Hewlett, *An Analysis of Market Failure. Externalities, Public Goods and Mixed Goods* (Gainesville, University Presses of Florida, 1977) 4–47; CJ Dahlman, ‘The Problem of Externality’ (1979) 22 *Journal of Law and Economics* 141; and JP Kalt, ‘Public Goods and the Theory of Government’ (1981) 1 *CATO Journal* 565.

⁷⁹ See: CE Lindblom, *The Market System. What It Is, How It Works, and What To Make of It* (New Haven, Yale University Press, 2001) 8–9 and 246; W Adams and HM Gray, *Monopoly in America. The Government as Promoter* (New York, MacMillan Publishing, 1955) 101; SL Carroll and LC Scott, ‘The Modification of Industry Performance through the Use of Government Monopsony Power’ (1975) 3 *Industrial Organization Review* 28; DK Round, ‘The Impact of Government Purchases on Market Performance in Australia’ (1984) 1 *Review of Industrial Organization* 94, 94–106; G Mele, ‘Appalti pubblici e concorrenza: regolamentazione e criticità funzionali del mercato nazionale’ (2007) 34 *Economia e politica industriale* 105; and MC García-Alonso and P Levine, ‘Strategic Procurement, Openness and Market Structure’ (2008) 26 *International Journal of Industrial Organization* 1180.

⁸⁰ OECD, *Public Procurement: The Role of Competition Authorities in Promoting Competition* (2007) 7. See also S Arrowsmith and K Hartley, ‘Introduction’ in *ibid* (eds) *Public Procurement* (Cheltenham, Edgar Elgar, 2002) ix; Arrowsmith (n 45) 2 and 6–7; S Nicinski, ‘Les évolutions du Droit administratif de la concurrence’ (2004) 14 *Actualité juridique—Droit administratif* 751; and A Laguerre, *Concurrence dans les marchés publics* (Paris, Berger–Levrault, 1989) 110. See also TA Mathisen and G Solvoll, ‘Competitive Tendering and Structural Changes: An Example from the Bus Industry’ (2008) 15 *Transport Policy* 1.

altering long-term incentives and competitive dynamics among public contractors.⁸¹ However, the role of public procurement in influencing the development of competitive markets has largely been neglected,⁸² and the study of public procurement regulations from a *market failure perspective* is underdeveloped.⁸³

The intuition behind the present approximation to the public procurement phenomenon from a market failure perspective is relatively simple and straightforward. The existence of public procurement regulations distorts demand (and sometimes offer) in the market since, in the absence of public procurement rules, the government would behave more like the private buyer (and public contractors would not adopt strategies any different from those pursued *vis-à-vis* the rest of buyers or users of a given product or service).⁸⁴ Therefore, inasmuch as public procurement rules impose (or allow for) a certain market behaviour that differs from that of the private buyer (because they aggregate buyer power, generate barriers to access public demand, impose certain standards not frequently used in the market, increase transaction costs—amongst other potential distortions), they constitute a potential source of market imperfection or market failure—in the sense that they will force the market equilibrium to depart from the optimal equilibrium in the absence of regulation.⁸⁵

The kinds of market distortions generated by public procurement regulations, *a priori*, seem to be primarily of two types. On the one hand, by means of price and non-price distortions, they generate a direct negative impact on market competition dynamics (primarily on the form of a *waterbed effect*, see §V.C below) and impose an efficiency loss on society (ie, a direct negative externality). On the other hand, they set up a market structure that, under certain conditions, increases the likelihood of collusion in the market (see below §V.D) and can further reduce the level of competition in the market by diminishing the long-term incentives of potential bidders to compete (ie, generates further derived negative externalities). Moreover, specific public procurement procedures can generate the room for additional market distortions (§V.E).

⁸¹ FM Scherer and D Ross, *Industrial Market Structure and Economic Performance*, 3rd edn (Boston, Houghton Mifflin, 1990) 146–48; N Dimitri et al, 'Introduction' in *ibid* (eds), *Handbook of Procurement* (Cambridge, Cambridge University Press, 2006) 3; Naegelen and Mougeot (n 7) 211. See also, OECD *Observer Policy Brief—Fighting Cartels in Public Procurement* (2008) 2, available at www.oecd.org/dataoecd/45/63/41415052.pdf; OFT (n **Error! Bookmark not defined.**) 2 and 40; and UK, HM Treasury, *Transforming Government Procurement* (2007) 4. In similar terms, see N Caldwell et al, 'Promoting Competitive Markets: The Role of Public Procurement' (2005) 11 *Journal of Purchasing and Supply Management* 242, 247; and L Cabral et al, 'Procuring Innovations' in N Dimitri et al (eds), *Handbook of Procurement* (Cambridge, Cambridge University Press, 2006) 483, 505.

⁸² See: Caldwell et al, *Promoting Competitive Markets* (2005) 242 and 247.

⁸³ The terms *market failure* and *market distortion* are used interchangeably to refer to the existence of factors that prevent the attainment of efficient market equilibrium. Generally, see FM Bator, 'The Anatomy of Market Failure' (1958) 72 *Quarterly Journal of Economics* 351; and above n 78.

⁸⁴ It should be reckoned that public authorities can, in some instances, conclude contracts that are subject to private contract law and, consequently, it could seem that, in those cases, they act without being subject to the constraints of public procurement law. However, at least in the EU, compliance with public procurement rules is mandatory, regardless of the (private or public) contract law applicable to the ensuing contracts—an issue that is outside the scope of this study (ch 1, §VII.A). Therefore, the remainder of the analysis will be conducted under the premise that public procurement rules are of relevance for all public procurement activities (with the only relative exception of public procurement conducted under the relevant value thresholds, or 'unregulated' procurement, on which see ch 6, §II.A.ii).

⁸⁵ Kettl (n 7) 32–35.

In order to justify fully the view that public procurement is a source of potential distortions in market competition dynamics, it is important to stress that—either implicitly or explicitly—*public procurement regulations are designed as market-like mechanisms*.⁸⁶ Given their strong reliance on competition amongst bidders in order to attain value for money (below chapter three), public procurement regulations have at their roots an embedded principle of competition (below chapter five) and try to incorporate, to the largest possible extent, market-like or competition-promoting mechanisms.⁸⁷ From an economic point of view, public procurement regulations should be seen as regulatory mechanisms that try to foster competition among potential sellers in order to extract the best possible economic conditions in all transactions conducted by the public buyer.⁸⁸ However, a fact that is usually overlooked is that *these market-like mechanisms do not substitute, but rather function within, the ‘actual’ or broader market*. In our view, by losing perspective and isolating the analysis of public procurement mechanisms from the market with which they interact, their effects on competition dynamics are generally not taken into consideration and, consequently, most conclusions and normative recommendations remain partial and, sometimes, flawed.

It is submitted that it is an excessive simplification to assume that public procurement regulations create a market-like environment or mechanism that operates in a vacuum, or in absolute isolation from the ‘actual’ markets where the goods and services procured by the public buyer are traded.⁸⁹ In this sense, it is important to stress that public procurement regulations only cover or discipline a certain part of the total market demand (with the only rare exception of pure *monopsonistic* or pure *public* markets; see above §ii) and, consequently, they generate a potential for market distortions through interaction with other agents developing non-regulated activities.

The more the market-like mechanisms created by public procurement regulations depart from the rules and dynamic trends of the ‘actual’ markets, the larger the potential for market distortions and the associated negative economic effects will be. Equally, the more public procurement regulations impose (or allow for) a market behaviour of the public buyer that departs from standard competitive trends in demand—particularly, by generating market (buying) power, or similarly disrupting non-market or regulatory effects—the more competition in the ‘actual’ market will be altered and, predictably, the larger the inefficiencies generated by this body of regulation will be.

Moreover, public procurement regulations can not only generate distortions *directly* associated to the market behaviour of the public buyer and induce *indirect* distortions derived from the activity of the remaining economic agents, but they can also give rise to

⁸⁶ See: BM Hoekman, ‘Introduction and Overview’ in *ibid* and PC Mavroidis (eds), *Law and Policy in Public Purchasing: the WTO Agreement on Government Procurement*, Studies in International Economics (Ann Arbor, University of Michigan Press, 1997) 3. See also ILO Schmidt and JB Rittaler, *A Critical Evaluation of the Chicago School of Antitrust Analysis*, Studies in Industrial Organisation no 9 (Boston, Kluwer, 1989) 10–11.

⁸⁷ See: C Bovis, *EC Public Procurement Law* (London, Longman, 1997) 3.

⁸⁸ In this regard, it is almost self-evident that the rules disciplining the market behaviour of potential suppliers and contractors should be the same in a public procurement and in an ‘open’ market context—inasmuch as the exercise of market power by power sellers or through collusion would generate the same negative economic effects in both settings.

⁸⁹ Such a simplification would only relate to a reality where public procurement took place in *pure monopsonistic markets*, where the public buyer constituted the only source of demand and, consequently, public procurement regulations applied to the whole market—hence, a situation where the market-like mechanism created by public procurement regulations *would be the entire market*. However, as already seen, most public procurement markets do not present these structural features (above §II).

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other detrimental economic effects inasmuch as they generate incentives for *strategic market and non-market behaviour*⁹⁰ and can significantly raise *transaction costs*.⁹¹ Finally, when public procurement regulations are driven by non-economic criteria—in pursuit of so-called ‘secondary policies’—the losses in efficiency can be even larger because this ‘instrumentalisation’ of public procurement further distorts competition in the markets concerned⁹² (below chapter three, §IV.A).

In this regard, and as a result of their various sources of potential market distortions, which have just been identified, it should be stressed that *public procurement regulations have the same flaws and present the same possibilities for the generation of market failures as any other body of sectoral regulation*—and, particularly, resemble the regulation of ‘special’ sectors (such as telecommunications, energy, postal services, etc), where the adoption of apparently market-like mechanisms can result in sub-optimal or inefficient outcomes.⁹³ It is submitted that, once this fact is brought to light, the need for basic competition principles to be called upon in order to correct or, at least minimise, the effect of public procurement regulations on market dynamics is clearly seen.

B. A Model for the Analysis of Public Buyer Behaviour and the Effects of Public Procurement Regulation

As already mentioned (above §C), competition policy analysis in public procurement markets will be particularly interesting and likely to contribute to the efficient functioning of dependent and commercial markets where, in different degrees, the public buyer holds significant (buying) market power and, consequently, can influence market dynamics.⁹⁴ Building upon this basic insight, the appraisal of the competitive effects of public procurement seems to be particularly suitable for the application of economic theory related to monopsonistic or quasi-monopsonistic markets. It is further submitted that, in order to analyse properly the potential competition distortions that public procurement can generate, a first approximation or partial analysis should focus on the pricing

⁹⁰ Indeed, public procurement regulations generate opportunities for strategic behaviour that can give rise to anti-competitive effects in the market; see OE Williamson, *The Mechanisms of Governance* (Oxford, Oxford University Press, 1996) 297; EA Blackstone, ‘Monopsony Power, Reciprocal Buying, and Government Contracts: The *General Dynamics Case*’ (1972) 17 *Antitrust Bulletin* 445; and RD Blair and DL Kaserman, *Antitrust Economics*, 2nd edn (Oxford, Oxford University Press, 2008) 423–24 and 432.

⁹¹ See: Trepte (n 5) 122–28. Also Mougeot and Naegelen, *Marchés publics et théorie économique: une guide de l’acheteur* (1997) 13–15. In general, on the importance of accounting for the negative effects that increases in transaction costs generate, OE Williamson, ‘Transaction-Cost Economics: The Governance of Contractual Relations’ (1979) 22 *Journal of Law and Economics* 233; *ibid*, ‘Transaction Cost Economics’ in R Schmalensee and RD Willig (eds), *Handbook of Industrial Organization* (Oxford, Elsevier, 1989) 136, *reprinted in* OE Williamson, *The Mechanisms of Governance* (1996) 54; and *ibid*, ‘Antitrust Lenses and the Uses of Transaction Cost Economics Reasoning’ in TM Jorde and DJ Teece (eds), *Antitrust, Innovation, and Competitiveness* (Oxford, Oxford University Press, 1992) 137.

⁹² Miller and Pierson, *Consistency of Federal Procurement Policies* (1964) 309; Brown et al (n 16).

⁹³ That is to say, regulatory intervention can sometimes generate ‘*derived externalities*’; see C Wolf Jr, *Markets or Governments. Choosing between Imperfect Alternatives* (Cambridge, MIT Press, 1988) 26, 77–79 and 165–66. Interestingly, Wolf considers that a more market-oriented approach to defence procurement would reduce the non-market failures that it generates. The argument is easily extendable to other markets. See generally *ibid*, ‘A Theory of Non-market Failure: Framework for Implementation Analysis’ (1979) 22 *Journal of Law and Economics* 107, and *ibid*, ‘Market and Non-Market Failures: Comparison and Assessment’ (1987) 7 *Journal of Public Policy* 43.

⁹⁴ OFT (n **Error! Bookmark not defined.**) 97.

distortions that it can produce in the market. The insights and conclusions derived from such pricing distortions will provide useful guidance for the analysis of non-pricing distortions—which will arguably be more relevant and widespread, and whose analysis is harder to specify in a model⁹⁵ (even if it should be kept in mind that the conclusions of the model based on pricing theory cannot be uncritically extended to other types of non-price competitive distortions—which might merit further scrutiny).

Regarding the first type of restrictions that can derive from public procurement (ie, pricing distortions), the analysis of the market dynamics and competitive impacts in this type of market with a *single dominant public buyer* can be represented as an extension of a basic monopsony model where there is no pure monopsonist, but a dominant buyer.⁹⁶ It is submitted that alternative models of analysis, such as those based on a concept of ‘*competition for the market*’ are not appropriate, since competition in public procurement markets takes place ‘*in the market*’ (except in the case of public concessions or similarly exceptional circumstances; see above §iii). Indeed, ‘competition for the market’ is not the relevant paradigm because most of the conditions required for a ‘bidding market’ to exist are not present in most public procurement markets (the conditions being that competition is ‘winner take all’, ‘lumpy’ and ‘begins afresh for each contract, and for each customer’, easy entry of new suppliers into the market, and the presence of a ‘bidding system’ or ‘bidding process’).⁹⁷ Therefore, the mere presence of a ‘bidding system’ is insufficient to warrant the analysis of public procurement markets under the paradigm of ‘competition for the market’ that characterises (economically-defined) bidding markets.

In the proposed model, the *single large buyer* is accompanied by several smaller buyers, who are termed *fringe buyers*.⁹⁸ Due to its size, the dominant buyer acts as a price setter,⁹⁹ whereas the fringe buyers act as price takers because their purchases are too small to influence price in the market.¹⁰⁰ Therefore, behaving competitively, fringe firms will buy the input up to the point where their collective demand equals the price set by the

⁹⁵ Indeed, the analysis of non-pricing competition—and, as a specification, of non-pricing competitive distortions—cannot be easily apprehended in widely accepted economic models. The issue is not new; see, GJ Stigler, ‘Price and Non-Price Competition’ (1968) 76 *Journal of Political Economy* 149; M Spence, ‘Nonprice Competition’ (1977) 67 *American Economic Review* 255; and, more recently, O Budzinski, *Modern Industrial Economics and Competition Policy: Open Problems and Possible Limits* (University of Southern Denmark, Working Paper No 93/09, 2009), available at www.sdu.dk/~media/Files/Om_SDU/Institutter/Miljo/ime/wp/budzinski93.ashx.

⁹⁶ On this market structure, characterised by the presence of a dominant buyer and a fringe of competitive buyers, Blair and Harrison, *Monopsony* (1993) 49–51; *ibid*, *Antitrust Policy and Monopsony* (1990) 322–24; and Blair and Durrance, *The Economics of Monopsony* (2008) 402–03.

⁹⁷ See: Klemperer, PD, ‘Competition Policy in Auctions and Bidding Markets’ in P Buccirossi (ed), *Handbook of Antitrust Economics* (Cambridge, MIT Press, 2008) 583, 585–89. Similarly, see Bishop and Walker, *Economics of EC Competition Law* (2002) 434–43.

⁹⁸ It should also be stressed that the model assumes the existence of economies of scale and perfectly competitive supply (ie, complies with the ‘zero profit condition’ as regards suppliers).

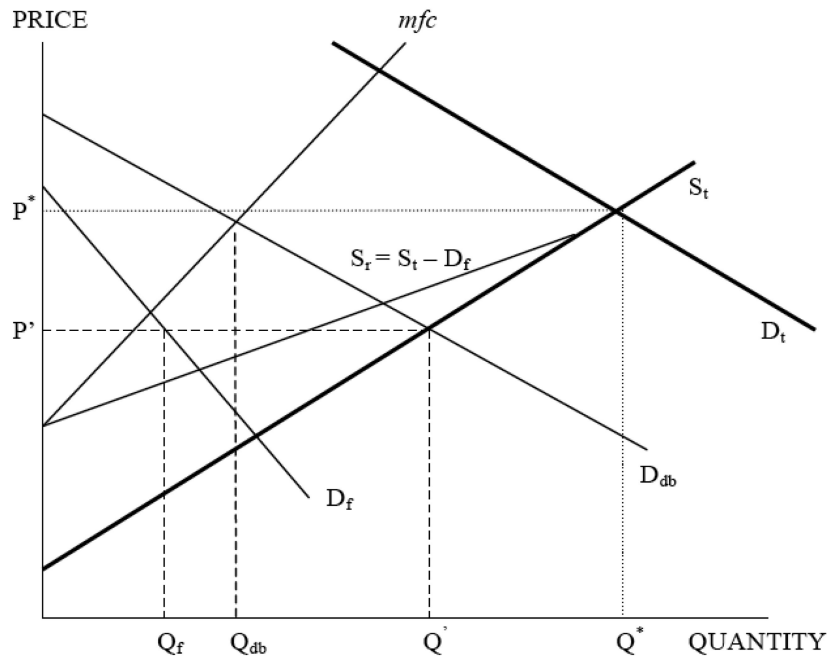
⁹⁹ In this dominant buyer framework, the greater the control of the market by the key buyer, in terms of its market share with respect to that of the competitive fringe, the greater is its ability to exert power to reduce price below the competitive level; see PW Dobson et al, *The Welfare Consequences of the Exercise of Buyer Power* (Office of Fair Trading, Research Paper No 16, 1998), available at www.oft.gov.uk/shared_oft/reports/comp_policy/oft239.pdf. However, measurement of buyer power cannot exclusively rely on market shares, but needs to take into account the critical effects of the elasticities of supply and of fringe demand; see RD Blair and JL Harrison, ‘The Measurement of Monopsony Power’ (1992) 37 *Antitrust Bulletin* 133, 142–50; and JM Jacobson and GJ Dorman, ‘Monopsony Revisited: A Comment of Blair and Harrison’ (1992) 37 *Antitrust Bulletin* 151, 165.

¹⁰⁰ The working of the model necessarily focuses on price formation. However, other public procurement practices not directly related to price can generate similar market failures. Similarly, see Dobson et al, *The Welfare Consequences of the Exercise of Buyer Power* (1998) 22–26.

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dominant buyer. In this setting, the dominant buyer's problem is to adjust its purchases to maximise profit subject to the competitive behaviour of the fringe buyers. Complications and further developments to this model might be required in cases where fringe buyers can be relatively large and/or the industry surrounding the public buyer is relatively concentrated. Similar issues arise when there are significant (or power) buyers other than the dominant public buyer and also, when the single or various dominant buyers face a supply that is not perfectly competitive, in which case issues regarding two-sided monopoly negotiations and the countervailing nature of monopsony power arise.¹⁰¹ However, regardless of the potential theoretical complications, it is submitted that the general economic insights required for the analyses conducted in other parts of the study can be properly grasped from the basic model regarding a *single dominant public buyer*.

Graph 1



Source: Own elaboration, based on RD Blair and JL Harrison, 'Antitrust Policy and Monopsony' 76 *Cornell Law Review* 297, 323 (1990–91).

¹⁰¹ For a general analysis of some of these alternative scenarios, see Scherer and Ross, *Industrial Market Structure and Economic Performance* (1990) 519–36; PW Dobson and M Waterson, 'Countervailing Power and Consumer Prices' (1997) 107 *Economic Journal* 418; and *ibid*, 'Retailer Power: Recent Developments and Policy Implications' (1999) 14 *Economic Policy* 133, 147 and ff. See also G Langus, *Essays in Competition Economics—Buyer Power under Imperfect Price Information and Uncertain Valuation*, (Dissertation (PhD) European University Institute, Department of Economics, 2008) available at cadmus.iue.it/dspace/bitstream/1814/9863/2/2008_Langus.pdf.

In the graph, D_f represents the demand by the competitive fringe, D_{db} represents the demand of the dominant buyer, and D_t represents the total demand curve (which aggregates D_f and D_{db}). S_t is the supply curve (or total supply). Knowing that, for any price that it sets, the competitive fringe will purchase the quantity where D_f equals the price (ie, the competitive fringe acts as a price taker); the dominant buyer incorporates this behaviour into its decision calculus by subtracting D_f from S_t to obtain the residual supply, which is denoted as S_r . The curve marginal to S_r , which is labelled *mfc*, represents the marginal factor cost for the dominant buyer (ie, its incremental costs incurred by employing one additional unit of input). The exercise of *monopsony power* leads the dominant buyer to purchase Q_{db} where the marginal factor cost (*mfc*) equals D_{db} , which determines price equal to P' from the residual supply. Circumscribing our analysis to the 'residual' market isolated by the dominant buyer, and in the absence of monopsony power, the dominant buyer would purchase a larger quantity determined by the intersection of S_r with D_{db} . Therefore, the exercise of monopsony power can be seen in the withholding of demand conducted by the dominant buyer, which decides to limit the purchases where *mfc* intersects D_{db} . At a price of P' the fringe will purchase Q_f where P' equals D_f . As a result, sellers will provide Q' , which is equal to the sum of Q_{db} and Q_f . The *mfc* exceeds the price of the input (P') and, consequently, *there is a loss in allocative efficiency derived from the fact that sub-optimal quantities of the input are traded*—ie, Q' is lower than the quantity that would result from a competitive equilibrium in this market (Q^*). As a result, the behaviour of the dominant buyer leads to the same sort of allocative inefficiency that would result from pure monopsony: *there are unrealised gains from further trade*. Since *mfc* exceeds P' , the value created by employing one more unit of the input exceeds the social cost of doing so (but not the *private* cost to the power buyer)—so that society would be better off by an increase in trade, while the dominant buyer would be worse off (since it would be paying a higher price for *all* of its inputs). In other words, the dominant buyer internalises the effect on market prices of its own demand and restricts it to the point where its position is optimal (ie, maximises its profits)—imposing a significant loss of social welfare.¹⁰² In short, the behaviour of the *dominant buyer leads to a deadweight social welfare loss analogous to that of pure monopsony*.¹⁰³

In rather simplified terms, the model shows how, as a result of the exercise of buying power by the (public) single dominant buyer, the price it pays for any given products or services is lower than under regular equilibrium conditions—which results in limited exchanges in the market (ie, reduced trade), potential foreclosure of suppliers, and worse market conditions for fringe buyers—both in terms of reduced variety and (in the long run) in higher prices. On the aggregate, there is a net loss of social welfare.

Even if it can be argued that the public buyer does not have a pricing behaviour identical to that of a hypothetical (private) single dominant buyer—because public buyers generally do not (willingly) withhold demand in order to lower prices in the market—in the public procurement setting, 'equivalent' pricing effects can be generated;¹⁰⁴ particularly by rules

¹⁰² For a succinct description of these effects and the necessary conditions for their generation, see RD Blair and DL Kaserman, *Antitrust Economics* (Homewood, Irwin Publications, 1985) 309–11; and RA Posner, *Economic Analysis of Law*, 7th edn (New York, Wolters Kluwer, 2007) 333–35.

¹⁰³ ET Sullivan and JL Harrison, *Understanding Antitrust and Its Economic Implications*, 4th edn (Newark, LexisNexis, 2003) 303. On the welfare effects of monopsony power, see Dobson et al (n 99).

¹⁰⁴ See: BundesKartellamt, *Buyer Power in Competition Law—Status and Perspectives* (2008) 3–4, available at www.bundeskartellamt.de/wEnglisch/download/pdf/2008_ProfTagung_E.pdf.

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imposing price caps that are lower than the prices that would be payable in an unregulated market equilibrium (P^*) or that, for other reasons, generate the same truncation of supply that is captured in the model (although such reasons admittedly might require some adjustments for their analysis as non-pricing distortions). In the public procurement setting, this ‘break-up’ of the supply function can be generated by rules and administrative practices that restrict the possibilities of some or most potential suppliers taking part in tendering procedures—so that, *de facto*, a ‘residual’ supply curve is artificially generated by public procurement rules and practices and, in the end, results in pricing distortions. In such cases of truncation of supply, the ‘excluded’ suppliers find their market opportunities limited to supplying fringe buyers (for which non-excluded suppliers also compete).¹⁰⁵ As a result, the market ‘shrinks’—since total quantities are reduced if compared with the optimal equilibrium—and social welfare is consequently reduced.¹⁰⁶ In extreme cases, the restrictions imposed by the public procurement rules and practices can be such as to effectively break up the market in two: one exclusively for the public buyer and another for fringe buyers (who, then, become the only buyers in the ‘spun-off’ or ‘private’ market). It is submitted that these (pricing and non-pricing) effects of public procurement rules on market dynamics and the ensuing loss of social welfare will be largely the same in these cases and in the more stylised case considered in the model.¹⁰⁷

Moreover, this loss of social welfare is not the only effect generated by the behaviour of the dominant buyer, since it adds up to redistributive effects that result from the extraction of surplus by the dominant buyer from both suppliers and fringe buyers.¹⁰⁸ Even if these redistributive effects are neutral from an efficiency standpoint—and, consequently, in our view they should not be determinant factors in shaping a competition policy in the public procurement environment—given that the result is that the public buyer extracts value from other undertakings and/or consumers (depending on the type of market where competition-restrictive public procurement takes place), these redistributive effects might merit closer attention than in other economic settings.¹⁰⁹ It should also be recalled that the deadweight loss identified by the model refers only to *static welfare considerations* and that, from a dynamic perspective, *the exercise of monopsony power can generate additional detrimental welfare effects in the long run* arising from damage to the viability of producers and, probably, of all or some of the fringe buyers (at least if they develop downstream market activities). These additional effects will be further analysed (below §V.C).

Consequently, in our view, market distortions generated by dominant buyers (both public and private) can have a significant impact on social welfare and should constitute a primary focus of competition policy (above chapter one, §I.A). The extension of competition policy to public procurement should be concerned with this type of market failure

¹⁰⁵ Implicitly, the public buyer is considered an ‘obligatory trading partner’ because there are no sufficient or reasonable alternative sources of demand—which is consistent with the fact that the analysis is limited to publicly-dominated markets (§II.C above). This should not be strictly understood as requiring that *each and all* suppliers must contract with the public buyer in order to remain in the market—but that very few (or, at worst, none of them) can develop their activities viably without satisfying public demand.

¹⁰⁶ In similar terms, OFT (n **Error! Bookmark not defined.**) 128–33.

¹⁰⁷ Therefore, even if it may imply a substantial level of simplification (particularly as regards the analysis of non-pricing distortions), the model described above will be used as the basic analytical framework in the remainder of this section.

¹⁰⁸ This effect was stressed by OFT (n **Error! Bookmark not defined.**) 69.

¹⁰⁹ See: RG Noll, “Buyer Power” and Economic Policy’ (2005) 72 *Antitrust Law Journal* 589, 591–92.

and curb public procurement rules and practices that can generate effects analogous to those of pure monopsony—even if they result from non-price distortions generated by the public buyer, ie, from inefficient public procurement rules and practices.

In general, competition concerns generated by public procurement can be classified in three categories: *category I* refers to the failure by the public sector to exercise countervailing market power against suppliers with market power; *category II* identifies restrictions on competition arising from procurement practices such as participation restrictions, high participation costs, excessive contract aggregation or long-term contracts, as well as additional long-term effects and effects on other buyers (ie, *waterbed* or *knock-on effects*); and *category III* refers to an excessive focus on short-run price competition at the expense of long-run, non-price competition.¹¹⁰ This study will be particularly concerned with *category II effects*, since these are the ones that can generate clearer negative impacts on competitive dynamics, as well as those that might be easier to correct by means of a system of more competition-oriented public procurement rules.

C. Direct Competition-Distorting Effects: Waterbed Effects

As a specification of the detrimental welfare effects that competition-distorting public procurement can generate according to the extension of the ‘classical’ monopsony model just reviewed, the distortions that can arise from the behaviour of the public buyer can also be analysed from the perspective of the creation of *waterbed effects* in the market. The term ‘*waterbed effects*’ is normally used to refer to situations whereby differential buyer power results in a gain for some buyers at both the relative and absolute expense of other buyers.¹¹¹ Ultimately, as a result of this waterbed effect, welfare is likely to be reduced—be it a result of increases in prices for the rivals of the power buyer (assuming certain additional conditions leading to price discrimination are met),¹¹² or be it a result of the exit of weaker suppliers or fringe competitors from the market.¹¹³ Indeed, if the rise of a powerful buyer erodes suppliers’ profits, then in the long run some suppliers may be forced to exit or merge with other suppliers in order to survive. This may lead, in particular, to a rise in the wholesale prices faced by less powerful retailers.¹¹⁴ As a result of

¹¹⁰ OFT (n Error! Bookmark not defined.) 23 and 142–47.

¹¹¹ The most characteristic use of the expression ‘waterbed effect’ is as a shorthand term for a situation in which (non-cost-related) price reductions are negotiated with suppliers by large buyers and result in higher prices being charged by suppliers to smaller buyers. The expression was coined by the UK’s competition authorities in a series of inquiries into the grocery retailing sector. See R Inderst and TM Valletti, *Buyer Power and the ‘Waterbed Effect’* (CEPR Working Paper, 2007), available at www3.imperial.ac.uk/portal/pls/portallive/docs/1/7799702.pdf. For a general overview of the abovementioned sectoral inquiries, with a clear focus on buyer power, PW Dobson, ‘Exploiting Buyer Power: Lessons from the British Grocery Trade’ (2004–2005) 72 *Antitrust Law Journal* 529.

¹¹² PW Dobson and R Inderst, ‘Differential Buyer Power and the Waterbed Effect: Do Strong Buyers Benefit or Harm Consumers?’ (2007) 28 *European Competition Law Review* 393, 393 and 397–99; and *ibid*, ‘The Waterbed Effect: Where Buying and Selling Power Come Together’ (2008) 225 *Wisconsin Law Review* 331, 333 and 341–52. See also AA Foer, ‘Mr Magoo Visits Wal-Mart: Finding the Right Lens for Antitrust’ (2006–2007) 39 *Connecticut Law Review* 1307, 1326–27.

¹¹³ See: A Majumdar, *Waterbed Effects, ‘Gatekeepers’ and Buyer Mergers* (University of East Anglia, CCP Working Paper 05–7, 2006) available at else.econ.ucl.ac.uk/conferences/supermarket/maj.pdf. See also WS Grimes, ‘Buyer Power and Retail Gatekeeper Power: Protecting Competition and the Atomistic Seller’ (2004–2005) 72 *Antitrust Law Journal* 563, 566 fn 14.

¹¹⁴ See: R Inderst and N Mazzarotto, ‘Buyer Power in Distribution’ in ABA, *Issues in Competition Law and Policy* (Chicago, ABA Section of Antitrust Law, 2008) 1953, 1965–68.

this additional concentration of the upstream industry and higher wholesale prices, fringe input buyers can eventually be forced to exit the downstream market. The aggregate effect of the reduction in competition in both wholesale and retail markets is very likely to produce a loss of welfare.¹¹⁵

Even if waterbed effects have so far been analysed in wholesale markets or markets for intermediate products—where the anti-competitive effect leading to a loss in consumer welfare largely derives from the distortions of market competition in the downstream market (and where they can be more easily analysed in standard pricing models), public procurement both in final products markets and in wholesale markets (even in those cases where the public buyer does not compete downstream with the other (fringe) buyers of the intermediate product) can also generate market distortions of a ‘waterbed-type’ (even if as a consequence of non-price elements)¹¹⁶ and, particularly, can result in higher prices in the non-public fringe of the market (and, particularly, for consumers).¹¹⁷ In these instances, the waterbed effect generated by public procurement regulations and administrative practices is highly likely to affect welfare negatively.¹¹⁸

The waterbed effect in certain ‘public procurement’ markets (ie, in *exclusive markets* and in other ‘*publicly-dominated*’ markets) might be less self-evident than in other markets because the public buyer is generally not considered a (buying) competitor of the undertakings procuring inputs for their market activities or of the consumers towards which the products are finally marketed. However, from an economic perspective, whenever the public buyer sources goods, services or works that could as well be demanded by undertakings or consumers—for the same or a different activity, this factor being irrelevant—it is effectively competing in the market for the purchase of those goods, the hiring of those services, or the commissioning of those works. Therefore, ‘*publicly-dominated*’ markets cannot be considered in isolation, nor can it be assumed that public demand does not interact with private demand. On the contrary, it is particularly

¹¹⁵ See: C Doyle and R Inderst, ‘Some Economics on the Treatment of Buyer Power in Antitrust’ (2007) 28 *European Competition Law Review* 210, 216; Dobson and Inderst, *The Waterbed Effect* (2008) 333; and Inderst and Valletti, *Buyer Power and the ‘Waterbed Effect’* (2007) 1–3. This dynamic potentially harmful effect for consumers is embedded in some competition policy guidance documents, such as the Communication from the Commission—Notice—Guidelines on the applicability of Article 81 of the EC Treaty to horizontal cooperation agreements [2001] OJ C3/2, 126 and 135. However, some studies report positive effects on suppliers’ incentives to innovate and increase competitiveness—which might generate dynamic efficiency; see Inderst and Mazzarotto, *Buyer Power in Distribution* (2008) 1970–72; R Inderst and C Wey, ‘Buyer Power and Supplier Incentives’ (2007) 51 *European Economic Review* 647; and *ibid*, *Countervailing Power and Dynamic Efficiency* (CEPR WP, 2007), available at www.nice.tu-berlin.de/fileadmin/documents/nice/forschung/countervailing_power_dynamic_efficiency_inderst_vey.pdf. Such potential dynamic efficiencies could offset, in part, the inefficiencies generated by waterbed effects in the same markets. However, this question remains an empirical one and needs to be taken into account on a case-by-case basis.

¹¹⁶ Along the same lines, the importance of waterbed effects in this context has been stressed by Bundeskartellamt, *Buyer Power in Competition Law* (2008) 3–4.

¹¹⁷ This theoretical possibility has already been supported by empirical studies; see M Duggan and FM Scott Morton, ‘The Distortionary Effects of Government Procurement: Evidence from Medicaid Prescription Drug Purchasing’ (2006) 121 *Quarterly Journal of Economics* 1, 23–24. A similar effect was previously reported by FM Scott Morton, ‘The Strategic Response by Pharmaceutical Firms to the Medicaid Most-Favored-Customer Rules’ (1997) 28 *RAND Journal of Economics* 269.

¹¹⁸ On the possibility that competitive distortions generated by a ‘waterbed effect’ result in a reduction of aggregate welfare—equivalent to the generation of a negative externality—see Grimes, *Buyer Power and Retail Gatekeeper Power* (2004–2005) 574–75. *Contra*, see DK Round, ‘Countervailing Power and a Government Purchasing Commission: An Opportunity to Promote Increased Competition in Australian Industries’ (1977) 36 *Australian Journal of Public Administration* 197, 201–04.

important to stress the existing buying competition between the public and other buyers (ie, fringe buyers) and to analyse the possible existence of *waterbed effects* that result from competition-distorting public procurement rules and that have a negative impact on the commercial conditions applicable to non-public buyers.¹¹⁹

In order to assess properly when the public buyer is to be found in such a competitive position, the characteristics of the sourced goods or services (or of the admissible suppliers) that are ‘created’ by public procurement regulations themselves should be disregarded because, *in the absence of public procurement regulations*, the public buyer would be shopping in the exact same markets as undertakings and consumers do (above §ii). For instance, when the public buyer sources information and communication technology (ICT) products, the fact that it restricts the potential supply to vendors able to prove they have more than a given number of years’ experience does not generate a separate ‘public’ market for ICT products where only those vendors and the public buyer are active (ie, an exclusive or monopsonistic market). It is submitted that, properly understood, this phenomenon should be analysed with the model proposed (above §V.B) as a ‘truncation’ of the supply curve by the public buyer—either willingly, or as a result of mandatory public procurement regulations¹²⁰—whereby it ‘skims’ the market and leaves the fringe buyers, for instance, more exposed to dealing with less experienced suppliers (and, from the opposite perspective, limits relatively inexperienced suppliers’ market opportunities to serve non-public buyers).

By selecting the type of vendors that have access to public demand (ie, the *residual* supply, in terms of the model), the public buyer is setting the framework for the appearance of waterbed effects. For instance, in the previous example, excluded vendors might need to raise their prices in the non-public tranche of the market in order to be able to recoup their fixed costs. Also, as they have a relatively large part of their production committed to serving the public buyer, experienced vendors can indulge in charging (or be pressed to charge, depending on the commercial conditions that they can extract from the public buyer) supra-competitive prices in the non-public tranche of the market. Alternatively, and depending on the specific concurring circumstances, public contractors can find themselves in a good position to undercut their rivals’ prices in the non-public tranche of the market, as a part of a predatory strategy to prevent them from acquiring the required experience and, thus, becoming effective competitors in the public tranche of the market.¹²¹ As a result of either of these strategies, the competitive dynamics of the market

¹¹⁹ As already mentioned (n 100), other types of (non-price) effects can also be identified as a result of public procurement rules and practices, such as an impact on the number of suppliers, the range of products available, or the technologies used; see OFT (n **Error! Bookmark not defined.**) 13–14.

¹²⁰ Indeed, in publicly-dominated markets, public procurement regulations can have the negative effect of ‘truncating’ the offer function—even to the point of artificially generating two markets for the same product. In general terms, the effect of such an artificial division of the market is well known (as it is exactly the same with collusive market fragmentation or allocation practices), and *both* the government and the remaining buyers (and, in the end, consumers) end up paying more than they would in the absence of public procurement regulations. Moreover, as has already been seen, such a division is more than likely to generate a deadweight welfare loss. Therefore, as shall be stressed later, the benefits of public procurement regulations—and particularly of the rules that are more likely to result in these types of negative economic effects—need to be assessed against these very relevant (non-trivial) economic costs.

¹²¹ Generally, this issue was analysed by CW Sherrer, ‘*Predatory Pricing: An Evaluation of its Potential for Abuse under Government Procurement Contracts*’ (1980–1981) 6 *Journal of Corporation Law* 531. Unfortunately, the case law of the ECJ in relation to ‘buyer power’ or monopsonistic situations is relatively limited. However, new trends of development in this area can be identified in other jurisdictions—remarkably, the US, and the

will be altered—compared to the conditions prevailing in a scenario free from public procurement rules and requirements—and, in a significant number of cases, the result will be negative from a welfare perspective.¹²²

In these cases, the waterbed effect does not necessarily derive from a strategy of exercise of buying power on the part of the public buyer, but more probably from similar price and non-price effects generated—maybe unnoticed and most probably unwillingly—by public procurement regulations and administrative practices. In these cases, it is remarkable that *the expected welfare losses derived from competition-restricting public procurement rules and practices could be larger than in the case of a ‘wilful’ monopsonist*, since the public buyer might not be in a position to capture most of the economic rent extracted from suppliers and other buyers—particularly where the economic rent generates additional compliance costs that are not fully recoverable through higher procurement prices by public contractors, or when price increases in the non-public tranche are only partially captured as producer surplus by government contractors—in which case, the economic rent generated by procurement regulations will mainly be dissipated in welfare losses as a result of inappropriate or excessive regulation of market activity. In such cases, a revision of public procurement rules with a more pro-competitive view can result in welfare increases without having a negative impact on the public buyer—and could even result in an improvement of the welfare of the public buyer depending on how the market forces allocate the increase in welfare derived from more efficient rules. Once the effects of more pro-competitive procurement are taken into account, the expected benefits on social welfare expansion are likely to be even larger.¹²³

In the light of this analysis, it is submitted that from an economic perspective public procurement rules should be designed in the most pro-competitive (or least competition-restricting) way possible, after conducting a cost–benefit analysis of the advantages that a given public procurement rule, practice or requirement can generate, and the waterbed and other (anti-)competitive effects that they are likely to cause (see below §V.D and §V.E). Acknowledging the existence of these possible distortions—that result in a welfare loss for society and that, somehow, can also result in a cross-subsidy of public procurement by other economic agents—can help measure the cost of public procurement

recent SCT decision in *Weyerhaeuser Co v Ross–Simmons Hardwood Lumber Co*, 549 US 312 (2007)—which might indicate that future developments of the ECJ case law might be anticipated, among others, in cases of predatory (over)bidding. An older US precedent involving anti-competitive (over)bidding—although as a result of collusive practices between the three largest buyers in the market—can be found in *American Tobacco v United States*, 328 US 781, 801–04 (1946). On the economics underlying predatory buying, see Blair and Harrison (n 16) 64–68 and 154–56; SC Salop, ‘Anticompetitive Overbuying by Power Buyers’ (2004–2005) 72 *Antitrust Law Journal* 669, 671; JB Kirkwood, ‘Buyer Power and Exclusionary Conduct: Should Brooke Group Set the Standards for Buyer-Induced Price Discrimination and Predatory Bidding’ (2004–2005) 72 *Antitrust Law Journal* 625; and RO Zerbe Jr, ‘Monopsony and the Ross–Simmons Case: A Comment on Salop and Kirkwood’ (2004–2005) 72 *Antitrust Law Journal* 717, 718–19. See also Grimes (n 113) 563. For a more general and comparative approach to the treatment of buyer power, see R Scheelings and JD Wright, ‘“Sui Generis”?: An Antitrust Analysis of Buyer Power in the US and the EU’ (2006) 39 *Akron Law Review* 207, 210.

¹²² Some of these situations could be captured by existing antitrust rules and remedies (particularly predatory strategies), but other types of milder waterbed effects or other practices that directly impose anti-competitive behaviour on public contractors could pass antitrust muster (see ch 4).

¹²³ On the importance of incorporating dynamic effect considerations into public procurement policy analysis, see A Finkelstein, ‘Static and Dynamic Effects of Health Policy: Evidence from the Vaccine Industry’ (2004) 119 *Quarterly Journal of Economics* 527.

regulations¹²⁴ and, consequently, lead to improvements in their design with the aim of reaching better results in terms of economic efficiency.

D. Indirect Competition-Distorting Effects: Increased Bidder Collusion and Other Effects of Price Signalling

*'The formal rules governing public procurement can make communication among rivals easier, promoting collusion among bidders. While collusion can emerge in both procurement and "ordinary" markets, procurement regulations may facilitate collusive arrangements.'*¹²⁵ Indeed, the fact that public procurement rules increase the likelihood of collusion among bidders has been convincingly proven in economic literature,¹²⁶ and has also been stressed for a long time by legal doctrine.¹²⁷ It is out of question that, under most common market conditions, procurement regulations significantly increase the transparency of the market and facilitate collusion among bidders through repeated interaction.¹²⁸

However, this key finding has not generated as strong a legislative reaction as could have been expected—and most public procurement regulations still contain numerous rules that tend to increase transparency and result in competition-restrictive outcomes (such as bid disclosure, pre-bid meetings, restrictions on the issuance of invitations to participate

¹²⁴ See: Duggan and Scott Morton, *Distortionary Effects of Government Procurement* (2006) 24.

¹²⁵ OECD, *Public Procurement: Role of Competition Authorities* (2007) 7.

¹²⁶ GJ Stigler, 'A Theory of Oligopoly' (1964) 72 *Journal of Political Economy* 44, 48; RP McAfee and J McMillan, 'Bidding Rings' (1992) 82 *American Economic Review* 579; D Konstadakopoulos, 'The Linked Oligopoly Concept in the Single European Market: Recent Evidence from Public Procurement' (1995) 5 *Public Procurement Law Review* 213, 216; GL Albano et al, 'Preventing Collusion in Public Procurement' in N Dimitri et al (eds), *Handbook of Procurement* (Cambridge, Cambridge University Press, 2006) 347, 351–52, 357–58 and 371; Johnson, Gains From a Unified European Community Public Procurement Market (1990) 1734; Klemperer, *Competition Policy in Auctions and Bidding Markets* (2008) 584 and 590–97; Blair and Kaserman, *Antitrust Economics* (2nd edn, 2008) 188; OECD, *Policy Brief—Fighting Cartels in Public Procurement* (2008) 3; OFT (n Error! Bookmark not defined.) 79–81; and G Spagnolo, *Self-Defeating Antitrust and Procurement Laws?* (Fondazione Eni Enrico Mattei Working Paper No 52.00, 2002), available at www.cepr.org/meets/wkcn/6/6607/papers/spagnolo.pdf.

¹²⁷ MA Flamme, *Traité théorique et pratique des marchés publics* (Brussels, Bruylant, 1969) I-182–3. See also WE Kovacic, *The Antitrust Government Contracts Handbook* (Chicago, ABA Section of Antitrust Law 1990) and PA Trepte, 'Public Procurement and the Community Competition Rules' (1993) 2 *Public Procurement Law Review* 93, 114.

¹²⁸ See: OECD, *Procurement Markets* (1999) 85–87 and 92–95; *ibid*, *Competition in Bidding Markets* (2006) 11, 19 and 23–32; BD Bernheim and MD Whinston, 'Multimarket Contact and Collusive Behavior' (1990) 21 *RAND Journal of Economics* 1; A Skrzypacz and H Hopenhayn, 'Tacit Collusion in Repeated Auctions' (2004) 114 *Journal of Economic Theory* 153; Albano et al, *Preventing Collusion in Procurement* (2006) 352–53; WE Kovacic et al, 'Bidding Rings and the Design of Anti-Collusive Measures for Auctions and Procurements' in N Dimitri et al (eds), *Handbook of Procurement* (Cambridge, Cambridge University Press, 2006) 381, 402; RA Miller, 'Economy, Efficiency and Effectiveness in Government Procurement' (1975–1976) 42 *Brooklyn Law Review* 208, 215–33; and JM Kuhlman, 'Price Fixing, Non-Price Competition and "Focal Point" Pricing: A Rose by Any Other Name?' (1978) 10 *Antitrust Law and Economics Review* 75. In extreme situations, the public buyer can even be the origin of restrictive practices, such as in those cases where the procurement officer contacts certain suppliers with the intention of simulating a competitive tender; see G Clamour, *Intérêt général et concurrence. Essai sur la pérennité du droit public en économie de marché* (Paris, Dalloz, 2006) 269. However, these cases should be dealt with more adequately by the anti-corruption instruments of public procurement regulations and, therefore, will not be discussed further (see ch 1, §VII.A).

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in bidding processes to a relatively pre-defined or stable group of firms, etc).¹²⁹ Nonetheless, the situation remains complex, since in some limited circumstances transparency can prove pro-competitive and ‘reserve prices’ might have a function to play in competitive scenarios that are not highly competitive,¹³⁰ and can be used strategically by the public buyer to induce competition among bidders.¹³¹ Moreover, price transparency can be a deterrent to private participation in some cases, particularly in industries where pricing information might be particularly sensitive.¹³² Therefore, choosing the adequate level of transparency is a complicated task—also because it has major implications as regards other objectives of the public procurement system (oversight, anti-fraud, etc)—and the generation of a pro-collusion scenario seems intrinsic to the system.

In the end, given that public procurement regulations are likely to facilitate collusion amongst bidders, it is not surprising that a large number of cartel cases prosecuted in recent years have taken place in public procurement settings,¹³³ and that the main focus of the (still very limited) antitrust enforcement efforts in the public procurement setting lies with bid-rigging and collusion amongst bidders.¹³⁴ Nonetheless, if the main concern of competition policy in the public procurement environment were to lie with *private* restrictions of competition (ie, bid rigging), there would not be a need to implement changes other than those already proposed¹³⁵—which will not be analysed in detail here (see chapter one). However, in our view, this is not the case.

Maybe what is most noteworthy from the perspective of public restrictions and distortions of competition in public procurement markets, the potential for *collusion or coordination among public buyers*,¹³⁶ and other *non-collusive effects* on bidders’ and buyers’

¹²⁹ However, some contracting authorities do adopt certain anti-collusion measures when designing their public procurement processes; see L Carpineti et al, ‘The Variety of Procurement Practice: Evidence from Public Procurement’ in N Dimitri et al (eds), *Handbook of Procurement* (Cambridge, Cambridge University Press, 2006) 14, 37–38.

¹³⁰ LM Ausubel and P Cramton, ‘Dynamic Auctions in Procurement’ in N Dimitri et al (eds), *Handbook of Procurement* (Cambridge, Cambridge University Press, 2006) 220, 226–27; Kovacic et al, *Bidding Rings and Anti-Collusive Measures* (2006) 401; and GL Albano et al, ‘Fostering Participation’ in N Dimitri et al (eds), *Handbook of Procurement* (Cambridge, Cambridge University Press, 2006) 267, 272–83.

¹³¹ McAfee and McMillan (n 22) 144–46; and Carpineti et al, *Variety of Procurement Practice* (2006) 26. See also CJ Thomas, ‘Using Reserve Prices to Deter Collusion in Procurement Competition’ (2005) 53 *Journal of Industrial Economics* 301, 303; and H Cai et al, ‘Reserve Price Signalling’ (2007) 135 *Journal of Economic Theory* 253.

¹³² Flamme, *Traité théorique et pratique des marchés publics* (1969) I-183.

¹³³ KL Haberbush, ‘Limiting the Government’s Exposure to Bid Rigging Schemes: A Critical Look at the Sealed Bidding Regime’ (2000–2001) 30 *Public Contract Law Journal* 97, 98; and RD Anderson and WE Kovacic, ‘Competition Policy and International Trade Liberalisation: Essential Complements to Ensure Good Performance in Public Procurement Markets’ (2009) 18 *Public Procurement Law Review* 67. For a description of cartel activity related to US procurement markets, see Kovacic et al (n 128) 381–88 and 407.

¹³⁴ See, amongst others, OECD (n 81) 3–5; and Haberbush, *Limiting the Government’s Exposure to Bid Rigging Schemes* (2000–2001) 114–20. However, it is important to stress that some of the proposed remedies or modifications to current public procurement regulations that could contribute to reducing the likelihood of collusion run counter to other important goals of procurement regulation (such as transparency, see ch 3, §IV.D) or, even more importantly, can have undesired (and maybe unexpected) negative consequences in market dynamics, since they tend to accentuate the waterbed effects described here (above §V.C). Therefore, their implementation should be subject to further consideration.

¹³⁵ An interesting summary of proposals for the reform of procurement regulations to reduce the likelihood of collusion can be found in OECD (n 80) 8–9 and 17–42.

¹³⁶ See: A Winterstein, ‘Nailing the Jellyfish: Social Security and Competition Law’ (1999) 6 *European Competition Law Review* 324, 333. A different issue is that of collusion between buyers and bidders, which has strong corruption components and, consequently, will not be analysed in detail (ch 1, §VII.A). On that issue, see

behaviour derived from *price signalling*,¹³⁷ have received significantly less attention by both legal and economic doctrine. Collusion or coordination among public buyers might be a result of public procurement rules or practices when they impose a certain degree of harmonisation or homogenisation of the economic conditions under which different (independent) public bodies conduct their procurement activities. For instance, if the maximum reservation prices used by (otherwise) independent public buyers are set by a centralised unit, the effect on prices will be the same as that derived from a private buying cartel. Similarly, even if there is no express or formal centralisation of pricing conditions, a problem of ‘collusion’ between buyers (loosely defined) can arise, since they are (or can be) fully informed of the prices paid in previous tenders by other public buyers. It is similar to an exchange of information between public purchasers (which, in the private sector, would be considered a buying cartel). This potentially negative effect, derived from a limitation of the (already scarce) competition amongst public buyers that could be expected to take place in publicly-dominated markets, has been largely omitted in the analysis of competition dynamics in public procurement markets. The same reasoning applies when independent buyers are forced to use common technical specifications, or when any other price or non-price aspect of their demand is (unduly) harmonised by regulations or administrative practices in the public procurement field. Therefore, in view of these economic insights, it seems that the transparency generally associated to public procurement procedures should be minimised to the maximum possible extent when designing the procurement system.

E. Other Competition-Distorting Effects

Additional competition distorting effects can derive from tendering procedures which generate significant flows of information between the candidates and the public buyer, and amongst candidates. In cases where the procurement process facilitates the exchange of information that would otherwise remain confidential to the parties, there seems to be scope for further restrictions of competition, both generated by the public buyer or as a result of coordination or collusion amongst candidates. That seems to be the case of particularly complex tender procedures and, especially, of competitive dialogue. This new procedure was introduced by Directive 2004/18.¹³⁸ Its basic aim is to allow for a close cooperation between undertakings and public agencies in the definition of particularly complex projects.

AT Ingraham, ‘A Test for Collusion between a Bidder and an Auctioneer in Sealed-Bid Auctions’ (2005) 4 *Berkeley Electronic Journal of Economic Analysis and Policy* 10.

¹³⁷ See: M Dufwenberg and U Gneezy, ‘Information Disclosure in Auctions: An Experiment’ (2002) 48 *Journal of Economic Behavior and Organization* 431, 442; RM Isaac and JM Walker, ‘Information and Conspiracy in Sealed-Bid Auctions’ (1985) 6 *Journal of Economic Behavior and Organization* 139, 140–41 and 146–49; A Ockenfels and R Selten, ‘Impulse Balance Equilibrium and Feedback in First Price Auctions’ (2005) 51 *Games and Economic Behavior* 155; and S Arrowsmith et al, *Regulating Public Procurement: National and International Perspectives* (London, Kluwer Law International, 2000) 440.

¹³⁸ For a description of the new competitive dialogue procedure, see A Rubach-Larsen, ‘Competitive Dialogue’ in R Nielsen and S Treumer (eds), *New EU Public Procurement Directives* (Copenhagen, DJØF Publishing, 2005) 67; and S Treumer, ‘Competitive Dialogue’ (2004) 13 *Public Procurement Law Review* 178. See also C Bovis, ‘Public Procurement in the European Union: Lessons from the Past and Insights to the Future’ (2005–2006) 12 *Columbia Journal of European Law* 53, 86–88; and *ibid*, *EC Public Procurement* (2006) 171–73 (for further details, ch 6, §II.A.ii).

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The scope and purpose of the new competitive dialogue procedure makes it particularly prone to the generation of competitive distortions. Given that contracting authorities who carry out particularly complex projects might resort to this procedure when they find it objectively impossible to define the means of satisfying their needs or of assessing what the market can offer in the way of technical solutions and/or financial/legal solutions, their need to rely strongly on tenderers' proposals and *know-how* and to try to find a common solution—or, at least, a common 'core' definition of the project that operates as the basis for (price) competition within the tender procedure—sets the stage for important distortions of competition to take place and, most importantly, for *technical levelling*¹³⁹ and *price signalling*.¹⁴⁰

EU public procurement directives have established certain mechanisms to try to prevent these undesired effects, such as the provision that the solutions proposed by a bidder cannot be disclosed to other tenderers or to third parties without its previous consent [art 29(3) *in fine* dir 2004/18]. However, the practical implications of such a *Chinese wall* or *ban on cherry-picking* remain largely controversial¹⁴¹ and the development of competitive dialogue itself is particularly prone to *leakage of information*, especially because the dialogue that is to take place in the stage before the invitation to tender is designed to cover *all aspects of the contract* [art 29(3) dir 2004/18], *including price*.¹⁴² Besides, in this setting, tenderers could find incentives to agree to such disclosure of proposals and other confidential information for collusive (or strategic) purposes—and the fact that the contracting authority mediates among them should not insulate the practice from standard competition law scrutiny.

Therefore, public procurement regulations—particularly when they opt for apparently flexible solutions that generate increased scope for exchanges of information or technical levelling (such as the new competitive dialogue procedure)—can lead to additional direct and indirect competition distortions, which should be taken into account and minimised in order to construct a more competition-oriented system.

VI. Conclusions to this Chapter

The brief review of the economics of public procurement conducted in this chapter offers some preliminary conclusions that should inform the analyses to be conducted in the rest of the study.

¹³⁹ See: SW Feldman, 'Traversing the Tightrope between Meaningful Discussions and Improper Practices in Negotiated Federal Acquisitions: Technical Transfusion, Technical Levelling, and Auction Techniques' (1987–1988) 17 *Public Contract Law Journal* 211.

¹⁴⁰ A risk already pointed out in the Green paper of the Commission—Public procurement in the European Union: "Exploring the way forward" [COM(96) 583]. Similarly, Treumer, *Competitive Dialogue* (2004) 186. See also Trepte (n 5) 279. However, this risk has nonetheless been underestimated or simply overseen by some commentators; eg, Rubach-Larsen, *Competitive Dialogue* (2005) 76.

¹⁴¹ Since, for instance, a confidentiality waiver could be imposed as a condition to participate in the tender; see Treumer (n 138) 182. *Contra*, Rubach-Larsen (n 138) 76–77. Concern has been expressed as to the impossibility of the buyer coming up with a combined solution constructed upon different parts of several bidders' proposals (as a potential instance of unnecessary rigidity); see Trepte (n 57) 61–62.

¹⁴² See: Rubach-Larsen (n 138) 75; and Treumer (n 138) 185.