

PUBLIC POLICY FOR THE

Private sector

Note No. 159

November 1998

Michael Klein

Infrastructure Concessions—To Auction or Not to Auction?

This is the second in a series of four Notes on bidding for infrastructure concessions. The other three in the series examine how concession design affects competition in bidding and the sustainability of the contract, how to avoid the winner's curse, and the case for rebidding.

Should a conceding authority auction off or negotiate a contract for an exclusive private infrastructure deal? Advocates of negotiation often argue that a formal competition may take too much time, that the costs of preparing bids may be excessive, and that innovation may be discouraged. But proponents of competitive bidding argue that there are ways to address these concerns without sacrificing the bidding process. Moreover, they argue, competition may yield a better deal for the conceding authority and enhance the transparency of the process, making the transaction more politically sustainable. This Note examines the arguments. Other issues come into play when the decision is whether to rebid a concession, because of the incentives for investment and maintenance that the incumbent faces; these issues are dealt with in a companion Note.

It is true, of course, that immediately awarding contracts rather than going through a bidding process can cut implementation times. Some of the early fast-track power projects in the Philippines were completed in less than a year. The costs were high—more than 13 cents a kilowatt-hour (kwh), compared with 5 to 7 cents for later plants that were competitively bid. But the costs were much lower than the cost of not having the electricity available, estimated to exceed 50 cents a kwh.

But even if speed is a key goal, some preconditions should be met. The conceding authority needs a list of reputable concessionaires. The project and contract have to be well defined. Some negotiation is inevitable. Finally, the authority needs a fallback option in case the first company chosen drops out or turns out to be unsuitable—and to make negotiation halfway meaningful. Thus, organizing a quick competition among three or four reputable companies might lose a little more time, but not much, unless a government is prepared to

compromise heavily on price and simply go to a company with an open-ended or generous contract, relying on the company's interest in protecting its reputation to limit price and ensure decent performance.

The costs of bidding

Also true is that the costs of preparing several bids can be prohibitively large relative to the contract amount. Competitive bidding for small water utilities, for example, each supplying just a few thousand customers, might not justify the transaction costs. One option is to pool municipalities and have them auction a single, large concession. Such pooling, though normally without bidding, is widely practiced by municipal water systems in France. Another common way to limit the costs of bidding is to restrict the number of bidders through a short-listing procedure. Often governments select only about four bidders from those technically and financially qualified. Alternatively, a government could select, for example, the four





bidders willing to offer the largest performance bonds and then have them bid on the main bid criterion. That would ensure that the most confident and creditworthy parties participate in the final bid.

A third option is to have consumers share the costs of bid preparation. Sharing of bid costs is generally allowed under the United Kingdom's private finance initiative (up to 50 percent) and has been used for Eurotunnel and the Athens airport. The shared bid costs are included in the total costs to be recovered from consumers or the conceding authority. Under any system consumers eventually pay for bid costs through tariffs, but with cost sharing they will also benefit to the extent that it intensifies competition. The main benefit occurs in situations where the number of bidders is raised from one to two. In other cases, where a reasonable number of bidders would bid anyway, the rationale for cost sharing would depend on the risk aversion of bidders, as cost sharing would lower their costs of risk bearing.

All these options assume that the costs of bidding are outweighed by the gains from competition. But determining *ex ante* whether that is likely to be the case is difficult. Better criteria are still needed to make such determinations.

Innovation

Competitive bidding schemes, which specify a problem to solve and performance standards to meet, can leave the private sector free to come up with new solutions. Private sector companies might also present governments with unsolicited project proposals with important innovations—proposing a new type of project, or a new solution to a known problem, or new ways of defining performance standards.

If the conceding authority used such ideas to formulate a competitive tender, it would discourage private firms from developing them. So it is in governments' interest to protect the intellectual property embodied in unsolicited bids. The problem is, of course, knowing

whether an idea is really a good one and whether a proposed deal can be adequately negotiated by the conceding authority. There are several basic options for combining incentives for firms to develop ideas with the benefits of competitive bidding. Chile's concession system allows the government to offer a bid premium for good ideas in proposals and then to announce an idea in a tender to determine which firm can best implement it. This method has been used in a Chilean toll road project. A similar option is to hold a design competition before writing the concession tender. Though common for architectural problems, formal design competitions are rare in concessions. Concession-type arrangements tend to be designed by the conceding authority with the help of consultants and inputs from industry.

A promising avenue for combining incentives for innovation with elements of competition has long been part of Spanish administrative law and is also included in the build-operate-transfer (BOT) law of the Philippines. When the conceding authority receives an innovative unsolicited proposal, it announces the broad nature of the proposal, then gives potential competitors ninety days to come forward with an alternative proposal. Comparing proposals generated in this way can be complicated and requires much discretion by the evaluating authority.

In practice, in many bidding processes bidders learn about competing bids while the bids are being evaluated, and they often expect leaks. In such cases special rules to protect innovative ideas in a bid will have little effect.

Transparency

Transparency of the award process—and with it, long-term political sustainability—tend to be enhanced by competitive bidding conducted under clear rules. But firms argue, correctly, that competitions are a sham and a waste when the rules of the game are not clearly defined. Bidders are unwilling to enter competitions where winning depends on political discretion

rather than a professional assessment of the merits of bids against published criteria.

Some firms argue that conceding authorities should resort to negotiated deals in situations where the rules of the game have not been made clear in credible ways. This, they contend, would attract the interest of better-quality firms and be a better learning process for the conceding authority than an ill-conceived attempt to organize a bidding competition. There may be merit to the argument as long as the government chooses a reputable company to deal with. But that may not happen. And if the government is intent on learning, it could do so in designing a competition.

Transparency is another word for limiting government discretion. For long-term sustainability of projects, firms should support transparency. But transparency also means sacrificing some short-run profit opportunities. Thus insistence on transparent rules—in particular, competitive award procedures—is a reasonable way of selecting both good governments and firms interested in the long term.

Bargaining strength

A key point of competitions is, of course, to improve the bargaining power of the conceding authority. And it is by submitting to clear bidding rules, rather than by negotiating, that the conceding authority is likely to elicit the best possible deals from firms. Both theory and evidence support this view (Bulow and Klemperer 1994; Kwoka 1996; and Domberger, Meadowcroft, and Thompson 1994).

But the effect of bidding is weakened if the choice of winners requires a fair amount of discretion. The more unavoidable discretion is, the weaker the case for bidding becomes relative to negotiation, and the more the competition will look like a form of competitive negotiation.

The need for discretion arises from the difficulty of comparing and scoring bids. First, qualified,

reputable bidders need to be chosen through a prequalification procedure. Prequalification may not be specific to a particular bidding; instead, a conceding authority might maintain something like a preapproved vendors list. While certain criteria can be specified, such as technical experience and financial strength, discretionary judgments about future developments for bidders can also be valuable. For example, if an experienced, financially strong public enterprise from another country would face major challenges if its home government were to withdraw subsidies or special protectionist measures, that might be taken into account in assessing the risk of relying on this company.

Second, the bids for concessions will vary in many dimensions, and will need to be compared along all these dimensions. The more dimensions there are, the more discretion the evaluators have in determining a final ranking. In a regular competition the problem of potentially excessive discretion can be reduced by using a two-stage bidding system. In the first stage technical bids are received. Following clarification with bidders, the bids are evaluated and a determination is made on which of them meet the performance requirements of the tender. Ideally, significant technical differences among these bids could be valued, such as the cost that different technologies impose on the environment. The second round of bidding is then based on a single quote on a single bid parameter—such as the price or the required subsidy—adjusted for any differences in valuations at the first stage. Discretion still exists in such a system, but because evaluators do not learn a crucial bid parameter until the end of stage two, their leeway for abuse is reduced. In some cases it may be crucial to have second-stage bids opened publicly, in the presence of auditors and bidders.

Even with the best of efforts cases will remain where comparisons among bids are very complex and some form of competitive negotiations will take place. Clarifications of bids after submission may start to resemble negotiations.



There may be actual parallel negotiations with several bidders. Or there may be one principal negotiation, but with a fallback so that the conceding authority can credibly threaten to terminate the negotiations. And sometimes the difficulties of comparing complex proposals may lead the conceding authority to revert to prescribing basic technical parameters, such as the location and technology for power projects. That was how the Thai government recently responded to its difficulties in evaluating numerous and varied offers for independent power generation.

One way to limit the scope for contract abuse is by setting benchmarks for performance. Suppose it easy to define a benchmark price for power, say 6 cents a kwh. This could be used as a maximum price in negotiations. But this method would work poorly for most concession-type arrangements, because general benchmarks tend to be unreliable. Pakistan has tried this scheme for power projects, but political debate about allegedly excessive profits threatens to undermine its viability.

Basic policy bias in favor of competition

Deciding whether to auction or to negotiate a particular concession is thus not entirely straightforward. When the conceding authority is a private company operating in a competitive market, there will be strong disciplines on it to prevent abuse of discretion. Regulated monopolies and government authorities, which are not subject to strong market disciplines, have greater scope for misusing discretion. So it is more important to bind their hands by imposing clear rules on the award process. But in limiting discretion some flexibility may be sacrificed in the interest of sustainable deals.

Most governments have started to adopt guidelines, in the form of laws or regulations, that require competitive bidding as the favored method of concession award. Yet at the same time they allow for exceptions on the well-argued grounds of speed, excessive transaction

costs, and protection of intellectual property rights. Examples of such guidelines include those for the private finance initiative in the United Kingdom, similar guidelines in several Australian states, and the concession or BOT laws of Chile, Hungary, and the Philippines. In France conceding authorities used to be free to chose the method of award. But, partly in response to concerns about corruption, basic rules now require conceding authorities to announce that they want to award a concession and thus give interested firms the opportunity to bid.

References

- Bulow, Jeremy, and Paul Klemperer. 1994. *Auctions vs. Negotiations*. NBER Working Paper 4608. Cambridge, Mass.: National Bureau of Economic Research.
- Domberger, S., S.A. Meadowcroft, and D.J. Thompson. 1994. "Competitive Tendering and Efficiency: The Case of Refuse Collection." In M. Bishop, J. Kay, and C. Mayer, eds., *Privatization and Economic Performance*. New York: Oxford University Press.
- Kwoka, John E. 1996. "Privatization, Deregulation, and Competition: A Survey of Effects on Economic Performance." PSD Occasional Paper 27. World Bank, Private Sector Development Department, Washington, D.C.
- NIEP (Association of National Independent Energy Producers). 1991. "Competing for Power: A Survey on Competitive Procurement Systems and Blueprint for the Future." Washington, D.C.

*Michael Klein (Michael.U.Klein@SI.shell.com),
Chief Economist, Shell, London*

Viewpoint is an open forum intended to encourage dissemination of and debate on ideas, innovations, and best practices for expanding the private sector. The views published are those of the authors and should not be attributed to the World Bank or any of its affiliated organizations. Nor do any of the conclusions represent official policy of the World Bank or of its Executive Directors or the countries they represent.

To order additional copies please call 202-458-1111 or contact Suzanne Smith, editor, Room F6P-188, The World Bank, 1818 H Street, NW, Washington, D.C. 20433, or Internet address ssmith7@worldbank.org. The series is also available on-line (www.worldbank.org/html/fpd/notes/).

♻️ Printed on recycled paper.