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Michael Klein

Rebidding for Concessions

This is the fourth 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, whether to auction or negotiate, and how to avoid the winner's curse.

The longer a concession lasts, the less effect the initial rounds of bidding will have on the terms of the concession over its full life. Much more influential will be periodic renegotiations or price reviews, which under standard concessions are hard to settle by competition (Williamson 1976). It has been suggested that competition could be brought to bear by periodically reaucting a concession, which would limit the potential for exercise of market power by concessionaires.¹ If contracts can be well written and rebidding is practical, periodic reaucting offers an effective solution to the natural monopoly problem. Price regulation may no longer be necessary, and rebidding may help with contract adjustment. Edwin Chadwick proposed this solution to the natural monopoly problem in 1859, and Harold Demsetz resurrected the notion in 1968. Rebidding for concession-type arrangements is therefore sometimes called a Chadwick-Demsetz auction. This Note examines the case for rebidding.

Rebidding is a practical option when assets are not specific to the concession. For example, garbage collection franchises can be reaucted periodically because if the incumbent loses, it can simply transfer assets (such as trucks) to another purpose or sell them. Bus routes also could be auctioned repeatedly. Studies suggest that auctioning short garbage collection concessions is more economical than either free entry (with garbage trucks chasing the same consumers) or long-lasting monopoly arrangements (Bartone and others 1991).

Problems arise when the concessionaire's assets are specific to the concession and are understood better by the incumbent than by the challengers. For example, water pipes normally cannot be dug out and used elsewhere economically. In such cases special incentive problems arise that complicate rebidding.

Valuing the incumbent's assets

A new entrant could always underbid the incumbent if the entrant could buy up the incumbent's assets cheaply. If the incumbent were forced to sell to the new entrant after losing the concession, that would tend to result in a "fire sale," undermining the long-run viability of the bidding process. But if the incumbent and new entrants were obliged to agree before the bidding on the price at which assets would change hands, the system might work. One way to force an agreement is to oblige a winning entrant to supply the service at the bid price for the service, regardless of whether it buys the incumbent's assets, or to pay a sizable penalty—guaranteed by a bid bond. In most cases this would lead efficient new entrants to agree on an asset price higher than the discounted cash flow expected by the less efficient incumbent.





The problem with any such rebidding scheme is that the prices demanded by the incumbent may systematically exceed the valuations of new entrants when new entrants cannot observe the quality of the assets, such as water pipelines in the ground. Just as in the market for used cars, the buyer may assume that prices offered by the seller are too high and refuse to enter into a contract. After all, the buyer knows that the incumbent has an incentive to skimp on investment and maintenance, precisely because of the possibility of losing the concession in rebidding.

Arguably, however, the seller's information advantage is shrinking as improved electronic measurement systems allow such assets as phone or electricity systems to be assessed quickly, cheaply, and comprehensively. Toll roads should also be auctionable—as should road systems, once pervasive road pricing creates road utilities. With underground pipes the hardest to inspect, water systems will remain the toughest challenge.

Special schemes may be needed to deal with incentives to skimp on investment and maintenance in cases where the quality of assets is hard to assess. Concession-specific assets may either be transferred to the winner of a rebidding (physical infrastructure) or stay with the incumbent (managerial know-how about the concession). When assets are transferable, any investment or improvement by the incumbent would benefit the new winner, reducing the incumbent's interest in investing in or maintaining the assets. But when assets are not transferable, the incumbent has an absolute advantage during the rebidding. Thus in the first case the rebidding arrangements should give preference to the incumbent, and in the second they should establish a bias against the incumbent. How these effects balance is an empirical matter (Laffont and Tirole 1993).

In practice, most assets can be transferred. New winners routinely employ key staff of the incumbent and thus appropriate much of the human capital specific to the concession as well as the physical assets. It might therefore be argued that a bias in favor of the incumbent is

generally advisable. In the rebidding of complex concessions such biases do indeed occur. In France concessions have traditionally been awarded at the complete discretion of the conceding authority. That has usually meant that concessions are reawarded to the incumbent.

In Argentina rebidding is mandatory for the Buenos Aires ninety-nine-year electricity distribution concessions after the first fifteen years and then every ten years. Bidding is on the value of the concession assets, while the price remains as reviewed by the regulator. This system gives an infinite preference to the incumbent. The incumbent can always retain the concession by bidding an outrageous amount, which it pays to itself. More likely, of course, the incumbent will bid the amount it views as justified, and if another bidder wants to pay it more for quitting, so much the better. The benefits of the new winner's greater willingness to pay are all appropriated by the incumbent, not by the consumers, unless regulators decide to pass on some of the benefits to them.

A market for corporate control of concessions

In a sense the Argentine electricity concession rebidding scheme makes takeover bids mandatory every ten years. Takeover bids would extract greater value for shareholders under the right pricing policy.² They would also benefit consumers if regulators took the successful bid as evidence that prices could be lowered more. That, of course, might dampen the enthusiasm of potential bidders. Nevertheless, the successful rebid can provide extra information to the regulator. Even requiring the concessionaire to quote some shares on the capital market might help (Mayer and Jenkinsen 1997). Some evidence in this regard is provided by the dispute about retail power prices in the United Kingdom in 1995. The electricity regulator, Stephen Littlechild, changed his opinion on future prices after a hostile takeover bid prompted a defense by an electricity distributor revealing that it had a stronger financial position than the regulator had been made to believe.

If the benefits of rebidding can also be obtained by requiring concessions to be listed on the stock exchange and by allowing takeover bids, it is hard to see how mandatory periodic rebidding schemes like the Argentine scheme could improve on this. They may be justified when there are no effective takeover mechanisms.

Rebidding as a means to reduce regulatory discretion

Yet there may still be ways in which rebidding can help pass the benefits of greater efficiency to consumers. After all, one reason for allowing or requiring challenges to the ownership of a concession is to provide regulators with better information for price setting. But if regulators have the discretion to use such information to adjust prices, firms might be reluctant to stage takeovers. When they do make bids, they would figure in a discount anticipating regulatory reaction to the bid, including a risk premium to take into account the regulator's degree of discretion. Little can be done to prevent firms from taking into account the regulator's likely responses. In fact, it is good that they do so, because they should be satisfied with the business even if the regulator passes part of the efficiency gains to the consumers.

A formal system of rebidding might reduce the risk premium for regulatory discretion, however. Such a system could work as follows. To ensure that creditor and investor interests are adequately taken into account, the company would be valued on the basis of its debt and stock market capitalization. Bidding would first be on the net worth of the firm. If more than one bid exceeds some predetermined price, the bidding would switch to the lowest price to consumers. A bias would be provided in favor of the incumbent, but not an infinite or discretionary one. It could be, for example, a 10 percent preference, so that another bidder wins only if it can underbid the incumbent by more than 10 percent. This scheme would eliminate much of the discretion by regulators. Such preference systems are used in bidding for traditional contracts for equipment and civil works

and have also been used in radio spectrum auctions in the United States. A scheme of this type has also been discussed as an option for the Chilean water system.

Rebidding to strengthen reputational mechanisms and limit government discretion

Termination and rebidding options should be designed so as to create the strongest possible incentives for firms to develop and maintain reputation. Governments or regulators should allow bids only from reputable companies, such as by requiring some form of prequalification.³ That gives companies intending to bid for concessions in the future an interest in maintaining a good reputation. Interest in reputation seems to be effective in reducing companies' incentives to capriciously renegotiate concessions. In a study of 3,000 cable television franchises in the United States Zupan (1989) found that opportunistic renegotiation appeared to have taken place in only 60 cases.

The assessment of a company's reputation is often subjective. When tasks are contracted out by firms operating in competitive markets, the firm choosing the "concessionaire" has a strong interest in judging reputation efficiently. But when governments or regulated industries issue concessions, such discipline may be absent. That raises the question of whether government agencies should be allowed to assess reputations. The procurement rules governing the U.S. Department of Defense make it almost impossible to take reputation into account, while French mayors have almost unlimited discretion to evaluate concessionaires. What is required is a mechanism for taking "soft" information into account, as rating agencies do when they evaluate capital market participants.

Rebidding and elections

Voters, of course, use a rebidding mechanism that takes soft information into account when they choose political leaders in elections. They are willing to live with the obvious incentive



problems generated when politicians face re-election every four years or so. Voters can use any piece of information in making their choice. It could even be argued that incumbency gives politicians an advantage in elections like that recommended by the theory of rebidding. The widespread practice of term limits imposed in political systems where mistrust in politicians is high is also consistent with advocacy of rebidding.

In political elections voters award the monopoly of government power for a period—a concession of sorts. Should voters similarly be allowed to pick their favorite monopolist for a limited period? The issues are not more complex than those in many other elections. It is clearly practical to vote on many detailed issues, as demonstrated in California and Switzerland. The costs of conducting such elections are likely to fall in a world where electronic forms of information and voting are becoming cheap and ubiquitous.

Elections might favor price structures that benefit the “median voters” at the expense of poor or remote customers. After all, the incentives for voters are similar to those they face in choosing legislators who impose taxes. To the extent that cross-subsidies can be maintained in the infrastructure system, they would presumably tend to favor customers who consume at similar times and locations.

A future for rebidding

The argument that concessions should be awarded competitively rather than by negotiation applies just as much to their reaward, particularly to limit discretion by governments. The real issue is whether there should be a reaward. The possibility of reaward is, of course, the very essence of concessions as property rights with special termination options for government.⁴ The threat of termination should ideally be used to strengthen the concessionaire’s incentives to behave well so that it need never be exercised. Rebidding raises a host of complex issues. However, reaward is unavoidable

in the longer run. Many current water privatizations, for example, are really reawards. In current privatizations the asset valuation problem often is not confronted, as existing assets are provided free to the new concessionaire. But that does not reflect sound policy so much as desperation with the performance of public firms and the absence of private shareholdings in the incumbent firm. Rebidding is probably still the least imperfect system of reaward. It deserves to be tried more systematically.

- ¹ Of course, concessions are needed only when there are monopolies to be awarded. Otherwise, free market entry should prevail.
- ² The “concession” would have to be treated like a firm—that is, its full balance sheet (assets minus debt) should be bid for, not the assets alone. In fact, it may be best to think of the concession as simply a regulated firm, with the government retaining rights to retake or change ownership under certain conditions. Such changes in ownership are possible for regulated utilities in the United States. Witness the municipalization and demunicipalization of water utilities.
- ³ A prequalification requirement is also advisable in other markets. After a large German construction and housing company, Neue Heimat, went bankrupt over a decade ago, it was purchased by a private individual with neither relevant business experience nor any noteworthy wealth for 1 deutsche mark. Neue Heimat’s creditors saw to it that this transaction was undone.
- ⁴ Governments tend to have emergency rights to confiscate all sorts of property in times of war, such as houses, cars, or food. These rights can be interpreted as a way of dealing with hold-up problems.

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

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