

## Competition Policy and Concessions

**Where privatisation is not possible, are concessions preferable to public provision?**

**What is involved in designing a concession?**

**How are concessions awarded?**

**What effect does renegotiation have on the benefits from concessions?**

**What is the role of the competition agency in concessions?**

**For further information**

**For further reading**

**Where to contact us?**

### Introduction

Governments have long been engaged in providing goods or services to their citizens that could, in some form, be provided by the private sector. The trend over the past few decades, however, has been to transfer these functions, and the state-owned assets used to provide them, to private hands. The most common method, and the one usually preferred, is privatisation, or outright sale or transfer of ownership of the relevant assets to one or more private parties. A second, however, is concessions.

Concessions are often viewed as a substitute for privatisation when the latter is not feasible for political or legal reasons. An accepted definition of a concession is: a grant to a private firm of the right to operate a defined infrastructure service and to receive revenues deriving from it. The concessionaire takes possession of the relevant assets (but ownership usually remains with the government) and uses them to provide the relevant product or service according to the terms of the contract. A concession could be granted to operate an airport, for example, or to provide water to a municipality. There could be many parameters to the concession agreement, including specification of tariffs, of investment, of levels of service or of fees to be paid to the government. The agreement is of limited duration, typically from 5 to 30 years. Concessions are not substitutes for regulation. Where there is a need for regulation, as in a situation of natural monopoly, a regulatory regime may be created along with the concession.

Concessions often occur in situations where competition in the market is not feasible or not likely to flourish, because of natural monopoly or related structural conditions. Concessions are a way of providing competition for the market – there is competition for the contract – which provides many of the same benefits for consumers. ■

**Where privatisation is not possible, are concessions preferable to public provision?**

There is one overriding advantage in private provision: the private sector is usually more efficient. Because private operators focus on profits, they have strong incentives to reduce their costs. This is true even of private monopolies as compared to public ones. (But of course, consumers do not benefit from these efficiencies unless the lower costs are somehow passed on to them.) Private providers also have incentives to innovate, which benefits consumers.

There may be situations, however, in which a private provider can reduce costs by reducing quality, which harms consumers, and, importantly, government oversight cannot remedy the situation. It may not be possible for the government to observe and measure reductions in quality. In this situation, if competition is not feasible or is ineffective, if the opportunity for innovation is limited and if gaining a reputation as an efficient service provider is unimportant in the sector, continued public provision could be preferable. There is ongoing debate, however, about the frequency with which this situation occurs. Some would say that tools for measuring quality are becoming more sophisticated, and the risks associated with a properly designed concession are minimal.

The key, of course, is that the concession be properly designed and executed. If it is done badly, consumers will be harmed and public reaction will be negative and strong, with the result that there will be greater resistance to concessioning in the future, even if well-conceived. ■

**What is involved in designing a concession?**

The first stage in the concessioning process is design; that is, deciding on the structure of the concession and the duties and obligations of the concessionaire. This can be a highly complex undertaking. One important consideration is to ensure that as much as possible there will be competition in the market post-award. This means creating a market structure that favours competition. There are both horizontal and vertical aspects to consider.

At the horizontal level, it may be possible for more than one concessionaire to operate in a market. In the case of ports, for example, if two or more ports along a coastline are substitutes for one another then it could be advisable to select different concessionaires to operate them. Even within a single port, competition may be possible among operators of different terminals. Mobile telecommunications is another sector in which horizontal “splits” have been employed frequently, with good results. An important factor in evaluating such splits is whether there are significant economies of scale in the relevant market; if there are, creating too many concessions would sacrifice efficiency.

Vertical considerations at the design stage usually involve separating the operation of any natural monopoly component from other stages in which competition is possible. The electricity supply industry is often cited as one in which vertical separation is necessary. The electricity transmission grid is considered to be a natural monopoly, but electricity generation is not. An operator of both the grid and a generation facility could discriminate against its competitors in generation through its operation of the grid, harming competition in the generating market. Economies of scope, for example involving the operation of a port and of a monopoly railroad serving it, are also relevant.

Another component of concession design is the length of the contract. There are trade-offs when determining the duration of a concession. Long concessions create appropriate incentives for the concessionaire to make investments, including investing in maintenance, near the beginning of the concession. Short concessions exacerbate the problem of insufficient incentives to make investments near the end of a concession, and because they occur more frequently they increase bidders' costs. On the other hand, short concessions allow for more frequent competitive tendering, which can facilitate entry and ensure that any benefits of increased competition are reflected more promptly. Short concessions may be indicated where there is uncertainty about future market developments. A shorter period places the burden of that uncertainty on the government in the short run, but it will increase certainty in the competition for the subsequent concession.

A concession may be accompanied by the creation of a regulatory regime. If there is to be regulation, the appropriate regulatory structure and agency should be in place in advance of the concession award in order to reduce uncertainty faced by bidders. Elements that can affect profitability, such as universal service requirements, restrictions on increases in user tariffs or special social tariffs should be specified in advance, so that potential concessionaires can intelligently prepare their bids or negotiation strategies. In addition, if there is to be price regulation, the tradeoffs between different methodologies, such as price-cap and rate-of-return regulation, should be considered. ■

### **How are concessions awarded?**

This is where competition for the market occurs, and therefore it is a critical stage. Economic literature points strongly toward auctions as the most effective means of awarding concessions. Designing the auction is critical, however. A faulty auction design will negate the potential benefits of the process.

There are different types of auctions. For example, in an ascending-bid auction (also called an open, oral or English auction) the price is raised until only one bidder is left, and that bidder wins at the final price. In a first-price sealed-bid auction each bidder submits a single bid, no bidder sees what the others bid and the highest bidder wins at the price it has bid. There are variations of these two types of auctions. No one type of auction is always best in concessioning; different circumstances may dictate different auction designs.

Another consideration in designing a concession auction is selecting the criterion that will be the subject of the auction. Two are most frequently used: the fee that the concessionaire will pay to the government or the price, or tariff, that the concessionaire will charge to its customers. Experience has shown that the contract fee is the better criterion. Inevitably, tariffs will change in response to changes in the business environment, requiring new negotiations (discussed further below), which could result in the elimination of some of the benefits of competition achieved by the auction.

In any case, many commentators consider that the most important factors in ensuring a successful auction are two that are familiar to competition policy experts: preventing collusion and attracting entry, or a larger number of bidders. Collusion is facilitated by processes that permit communication among bidders. Apart from direct communication, for example in a secret meeting in a hotel room, bidders sometimes communicate through “signaling”. Bidders may communicate their intentions indirectly through statements in newspapers or by the way in which they structure their bids. The competition policy literature and case law are replete with examples of ingenious methods for signaling employed by cartel operators. The auction design can help to frustrate some of these methods. Sealed bidding may be better than open auction as a means of limiting opportunities for communication among bidders. There are other measures that can be taken, but again, each situation is unique and no one approach is always best.

There is another form of collusion in concessioning: collusion between corrupt government officials and private parties. It is obvious that preventing and punishing corruption should have the highest priority in law enforcement, not only in the concession environment but in all aspects of government. Corruption can be discouraged in concessioning by the use of formal, transparent award processes.

The second component of a competitive auction is number of bidders. It is intuitive that more bidders is better, and this is borne out by the economics literature. The concessioning agency must use its

best efforts, therefore, to attract qualified bidders to the auction. Measures for doing so include wider advertisement of the auction and reducing the cost of bid preparation. In some cases, the use of sealed bidding may have the effect of attracting weaker bidders, who may nevertheless have some chance of winning. Those bidders might shy away from open auctions, in which they would expect to drop out at a late stage, having nevertheless incurred the costs of preparing for the auction. Another problem might arise in situations of repeated concessions, where the incumbent would be perceived as having informational advantages, which could discourage new entrants. This could be overcome, at least partially, by providing better information to all bidders.

Finally, joint bidding by two or more parties, each of whom could bid separately, has the obvious effect of reducing the number of bidders. The concessioning authority could forbid joint bidding entirely, but this would have the negative effect of eliminating bidders who could only participate jointly. A middle ground is to prohibit the formation of joint bidding arrangements close in time to the auction. This would help to prevent strategic joint arrangements formed for the purpose of reducing competition.

Auctions are sometimes rejected as a means of awarding a concession when there are multiple criteria, such as an objective to provide the best mix of coverage, quality and price, and it is not considered possible to identify the “highest” bid. Experts caution against abandoning auctions, however, as the outcome for consumers when other methodologies are used is usually inferior. Two alternatives to auctions are negotiation and “beauty contests”.

Negotiations could take place with more than one potential concessionaire simultaneously; this process is sometimes called competitive negotiation. In this process, several potential bidders are contacted by the concessioning authority and invited to enter negotiations. During the negotiations they develop alternatives that would meet the concession requirements. Then the bidders submit their final offers on the basis of the solutions identified during the negotiations. After the government selects the winner, further negotiations complete the contract terms. A less satisfactory method of negotiation from the competition perspective is negotiating with a single provider at a time. It is also true that in any negotiation scenario the opportunities for corruption are greater than they are in an auction.

Beauty contests have many of the same characteristics as negotiations. In a beauty contest competitors are evaluated on the basis of pre-defined criteria, such as technical expertise, financial viability and

network coverage. Beauty contests have been criticised as lacking transparency and being subject to lobbying and political intervention. ■

### What effect does renegotiation have on the benefits from concessions?

Concession contracts are by nature “incomplete”, in that not all of the variables that affect their terms – for example, precise costs of providing a service or the amount of the service that will be demanded – can be known in advance. Over time, especially in concessions of long duration, the parties may have to enter into renegotiations in order to adjust the contract terms to marketplace realities.

But the opportunity for renegotiation can also promote opportunistic behaviour. A bidder may concede a great deal in the competitive award stage, with the hope or expectation that it can recoup these “losses” in renegotiation. After the award the balance of negotiating strength can shift dramatically in favour of the concessionaire. The winner can “hold up” the government by threatening to default, possibly depriving citizens of a vital product or service. There are many examples of such conduct.

The concessioning authority cannot completely eliminate the possibility of renegotiation, nor would it want to. Some steps that it could take to minimise the risk of opportunistic behaviour at the award stage, however, include: structure the contracts to create as much competition post-award as possible, thus providing the agency with more alternative service providers and thereby reducing the bargaining power of the concessionaires; avoid using an auction criterion that is more likely to be modified soon after the award, such as tariffs, or that is subject to manipulation, such as technical proposals; make it expensive for winners to default, for example by requiring performance bonds; provide for “step-in rights”, allowing government to take over the operation of a concession when the concessionaire is not performing according to specified standards; impose on the concessionaire an obligation to continue providing service until a new concessionaire has been chosen. ■

### What is the role of the competition agency in concessions?

The competition agency has an important role in concessions, and the agency should become involved early in the process. It can do so by means of competition advocacy during the design and award stages. It can assist the concessioning agency in designing the structure of the concession to maximise post-award competition, for example by recommending appropriate horizontal and vertical splits, as discussed above. It can advise on the award process, particularly in the selection of the most efficient means of award and on minimising the opportunities for collusion. If the process includes the creation



of a regulatory regime, the agency can provide input there as well, for example on the most efficient type of price regulation. It will not be sufficient for the agency merely to say, “Competition is good”, however. It must invest in acquiring some technical expertise in the sector involved, both to give the agency credibility and to enhance the usefulness of its advice.

Finally, the competition agency must vigorously enforce the competition law throughout the process. There should be no exemptions or exclusions from the competition law in sectors where there are concessions – the competition law should apply fully to them. The competition agency should of course be alert to the possibility for collusion at the award stage as well as post-award, in those parts of the sector where competition exists. Where the concessionaire is a monopolist the agency may have occasion to apply the abuse of dominance provisions of the competition law to its conduct, particularly where the conduct is exclusionary. Finally, the merger control law may apply, either to horizontal mergers between competing concessionaires or to vertical acquisitions by monopolist concessionaires that could have harmful effects in competitive markets. ■

### For further information

More information about this *Policy Brief* and the OECD Competition Division can be obtained from Edward Whitehorn, tel.: +33 1 45 24 83 81, e-mail: [Edward.whitehorn@oecd.org](mailto:Edward.whitehorn@oecd.org). Or visit the website: [www.oecd.org/competition](http://www.oecd.org/competition).



### For further reading

OECD (2001), **Recommendation of the Council Concerning Structural Separation in Regulated Industries**, see [www.oecd.org/competition](http://www.oecd.org/competition) under "Recommendations and Best Practices".

OECD (2001), **Restructuring Public Utilities for Competition**, ISBN 978-92-64-18726-9, 96 p., 48.

OECD (2006), **Access to Key Transport Facilities**, available for free download at: [www.oecd.org/dataoecd/39/14/37981556.pdf](http://www.oecd.org/dataoecd/39/14/37981556.pdf).

OECD (2005), **Structural Reform in the Rail Industry**, available for free download at: [www.oecd.org/dataoecd/7/14/35911008.pdf](http://www.oecd.org/dataoecd/7/14/35911008.pdf).

OECD (2004), **Regulating Market Activities by Public Sector**, available for free download at: [www.oecd.org/dataoecd/61/5/34305974.pdf](http://www.oecd.org/dataoecd/61/5/34305974.pdf).

OECD (2004), **Competition and Regulation in the Water Sector**, available for free download at: [www.oecd.org/dataoecd/44/1/33691325.pdf](http://www.oecd.org/dataoecd/44/1/33691325.pdf).

OECD (2003), **Non-commercial service obligations and liberalization**, available for free download at: [www.oecd.org/dataoecd/43/35/33691140.pdf](http://www.oecd.org/dataoecd/43/35/33691140.pdf).

OECD (2000), **Competition in local services**, available for free download at: [www.oecd.org/dataoecd/34/51/1920304.pdf](http://www.oecd.org/dataoecd/34/51/1920304.pdf).

OECD (1999), **Promoting competition in postal services**, available for free download at: [www.oecd.org/dataoecd/35/36/1920548.pdf](http://www.oecd.org/dataoecd/35/36/1920548.pdf).

OECD (1998), **Competition policy and international airport services**, available for free download at: [www.oecd.org/dataoecd/34/52/1920318.pdf](http://www.oecd.org/dataoecd/34/52/1920318.pdf).

---

OECD publications can be purchased from our online bookshop:  
[www.oecd.org/bookshop](http://www.oecd.org/bookshop)

OECD publications and statistical databases are also available via our online library:  
[www.SourceOECD.org](http://www.SourceOECD.org)

---

### Where to contact us?

#### OECD HEADQUARTERS

2, rue André-Pascal  
75775 PARIS Cedex 16  
Tel.: (33) 01 45 24 81 67  
Fax: (33) 01 45 24 19 50  
E-mail: [sales@oecd.org](mailto:sales@oecd.org)  
Internet: [www.oecd.org](http://www.oecd.org)

#### GERMANY

**OECD Berlin Centre**  
Schumannstrasse 10  
D-10117 BERLIN  
Tel.: (49-30) 288 8353  
Fax: (49-30) 288 83545  
E-mail:  
[berlin.contact@oecd.org](mailto:berlin.contact@oecd.org)  
Internet:  
[www.oecd.org/deutschland](http://www.oecd.org/deutschland)

#### JAPAN

**OECD Tokyo Centre**  
Nippon Press Center Bldg  
2-2-1 Uchisaiwaicho,  
Chiyoda-ku  
TOKYO 100-0011  
Tel.: (81-3) 5532 0021  
Fax: (81-3) 5532 0035  
E-mail: [center@oecdtokyo.org](mailto:center@oecdtokyo.org)  
Internet: [www.oecdtokyo.org](http://www.oecdtokyo.org)

#### MEXICO

**OECD Mexico Centre**  
Av. Presidente Mazaryk 526  
Colonia: Polanco  
C.P. 11560 MEXICO, D.F.  
Tel.: (00.52.55) 9138 6233  
Fax: (00.52.55) 5280 0480  
E-mail:  
[mexico.contact@oecd.org](mailto:mexico.contact@oecd.org)  
Internet:  
[www.oecd.org/centrodemexico](http://www.oecd.org/centrodemexico)

#### UNITED STATES

**OECD Washington Center**  
2001 L Street N.W., Suite 650  
WASHINGTON DC. 20036-4922  
Tel.: (1-202) 785 6323  
Fax: (1-202) 785 0350  
E-mail:  
[washington.contact@oecd.org](mailto:washington.contact@oecd.org)  
Internet: [www.oecdwash.org](http://www.oecdwash.org)  
Toll free: (1-800) 456 6323

The OECD Policy Briefs are prepared by the Public Affairs Division, Public Affairs and Communications Directorate. They are published under the responsibility of the Secretary-General.