

Managing the unintended consequences of competitive tendering.

Monopolies, public monopolies, competitive tendering: how and when should each be used under EU law?

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Abstract

This paper outlines the legal position in terms of EU regulations of the various options for delivering public services. It considers the situation where for a number of reasons the service is delivered by a public or private monopoly. The circumstances in which the procuring authority uses competitive tendering, regulation or some combination of both are outlined. The regulations around State aid and the Altmark and Teckal exemptions are explained. Crucially, for the Scottish ferry industry, the question of what happens when the domestic incumbent loses a contract is raised. The broad scope for taking into account social and environmental considerations in awarding a contract for the delivery of a public service are elucidated. The difficulty of ensuring such contracts are specified in a way that is both lawful and effective are explained. The paper concludes that regulation rather than tendering of public contracts may be a simpler and more effective method to ensure that the 'most economically advantageous' outcome is achieved.

I Introduction and background

Competitive tendering is required for important contracts for the supply of goods and services to public authorities. It is used for the grant of concessions giving the right to provide goods or services to the public. The purpose of requiring competitive tendering is, in popular terms, to get the best value for money, from private companies competing to provide services to the public in general.

Rights given by way of concession are frequently rights to monopolies. Monopolies can be privately or publicly owned. The justification given for a monopoly may be non-economic and social, as in the case of monopolies granted for gambling or for the sale of alcohol. When a monopoly concession is granted, the conventional explanation may be that a monopoly is needed to ensure that all available economies of scale and scope can be obtained, and passed on to users. Another conventional reason is that the services to be provided include some that are unavoidably unprofitable, and that these services, since they have to be paid for somehow, can most conveniently be paid for by cross-subsidising them from the revenue from profitable activities² If this option is chosen, the company involved needs

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² *Case C-320/91, Corbeau, EU: C: 1993: 2533*

to be protected from "cherry picking" by competitors who wish to provide only profitable services.

A second alternative, which would be a public subsidy to cover the cost of the unprofitable activities, would involve expense to taxpayers and cost accounting to estimate the cost of the activities to be subsidised. The monopoly might be justified by the need to give the investors an assurance of a profit in the long term if very large initial investment were needed in e.g. a large waste management plant, an airport or a toll-road. A third alternative is a publicly-owned enterprise which, if it has a monopoly, automatically cross-subsidises its operations to whatever extent may be necessary.

Public authorities often consider it necessary to ensure that certain services are made available to everyone (universal service) at a uniform cost. The most familiar example is the postal service. Other examples are utilities, water, gas, energy, health, transport, waste management, and communications (television, telephone and broadband). The combination of a universal service obligation and a uniform price frequently means that some of the services will necessarily be uneconomic to supply.

If it is decided to set up or maintain a monopoly, it may be thought necessary to decide for how long it should be granted, how it should be regulated, what obligations should be imposed, and how wide the exclusive rights granted should be. (For example, a monopoly of the right to provide shipping services to areas with few inhabitants would not extend to the right to provide air transport for passengers or goods). If the obligations imposed result in some services being uneconomic, it may be necessary to decide whether taxpayers should pay some of the cost, rather than relying only on cross-subsidisation. It will also be necessary to plan procedures for putting the monopoly up for competitive tender again and designed in such a way that as far as possible the incumbent enterprise will not have unbeatable advantages. If the company that obtains the monopoly is required or expected to invest in infrastructure, it will be essential to decide how that investment is to be financed.

Cross-subsidies can be of many different kinds. A shipping line with obligations to service less inhabited areas may subsidise its uneconomic winter services from its profitable summer operations, or its unprofitable passenger operations from profitable commercial operations. Or it could subsidise its services to less inhabited areas from the profits of busy routes. If it is decided not to have a monopoly, it is necessary to decide how uneconomic activities, resulting from universal service obligations, are to be paid for.

II The principles of EU law on State enterprises and monopolies

The principles of EU law on State enterprises and monopolies can be summarised as follows (cf. Temple Lang, 2008, Buendia Sierra, 1996, Blum and Logue, 1998, Jones and Sufrin, 2008, Edward and Lane 2013)

- Directive 2014/24 deals with public procurement in general, but this does not apply to transport, which is dealt with by Directive 2014/25.
- Member States must not adopt any measures that make EU competition law ineffective, or that make it likely that a company in a dominant position will abuse its dominance.
- European law does not prohibit publicly owned enterprises, and it allows monopolies to be set up and maintained if there are good reasons. Monopolies can be granted or maintained both for privately-owned and publicly-owned companies.

In theory, Member States can justify setting up or extending a monopoly only if that is necessary to achieve a legitimate (i.e. non-protectionist) purpose³, and (perhaps) if no less restrictive alternative would be appropriate. In practice, however, the justification for setting up or maintaining a monopoly is rarely looked at critically. No justification is required for setting up or maintaining a publicly-owned company.

All the competition rules apply even to State owned enterprises, subject to the exception for "Services of General Economic Interest", which is narrowly interpreted. Member States may exempt those Services from EU law rules, but only insofar as those rules would obstruct the performance of the specific tasks imposed on them. A company obliged to provide a service of general economic interest does not need to be publicly owned.

The most important justification for setting up a monopoly is that, without the exclusive rights conferred on it, it would not be possible for the enterprise to carry out its tasks "under economically acceptable conditions", that is, without the exclusive rights it would be impossible for it to have an expectation of being able to make an acceptable profit, on condition that it is reasonably efficient. It may not be necessary to show that no less restrictive alternative was available. However, a monopoly that would otherwise be justified is illegal if it cannot carry out efficiently the tasks assigned to it (eg a public employment agency without the resources needed to find jobs satisfactorily)⁴ or if it is necessarily involved in situations of conflict of interest (e.g. if it is given power to regulate its own

³ Case C-553, *Dimosia*, EU: C: 2014

⁴ Case C-41/90, *Hafner and Elser v. Macrotron*, EU: C: 1991: 1979

competitors, or given the duty to supply key services to them)⁵. If the monopoly is wider than is needed to enable the company to make a reasonable profit, the monopoly is illegal to the extent of the unnecessary restriction on competition. Even if a basic monopoly is justified, it may be unjustifiable to extend it⁶

A statutory monopoly is not required by EU law to be set up by competitive tender

If the Member State decides to finance the public service provider out of public funds, under the *Altmark* judgment⁷ payments that merely compensate for the cost of carrying out the service are not State aid. But the public service obligation must be clearly defined: the compensation must be calculated objectively and transparently and it must not exceed the cost of providing the service, plus a reasonable profit. If the enterprise is not chosen in a public procurement procedure, the compensation must be determined based on an analysis of the cost of a typical undertaking, well run, would have incurred in discharging the obligations, taking into account a reasonable profit. Unless all four conditions are fulfilled, there is State aid. The effect of this is that the rules on State aid are stricter than the rules on public monopolies, at least as the latter are applied in practice.

A public authority can award a contract without a competitive tender process if the authority controls the economic entity, and the entity carries out the essential part of its activities with the authority⁸.

There are also sector-specific provisions of EU law on various public services, in terms of universality, continuity, quality, affordability and protection of consumers and users. It is assumed that as far as possible public services should be provided by competitive markets.

A monopoly that is an "enterprise" (unlike eg a compulsory health insurance scheme based on "solidarity") is subject to all the usual obligations of a dominant enterprise under Article 102 TFEU (Treaty on the Functioning of the European Union), in addition to whatever obligations are imposed by the measure establishing the monopoly.

Although these principles are fairly clearly established, they are not always strictly enforced.

⁵ Case C-163/96, *Raso* EU: C: 1998: 533

⁶ Case C-475/99, *Ambulanz Glockner*, EU: C: 2001: 8089

⁷ Case C-280/00 *Altmark*, EU: C: 2003: 7747

⁸ This is known as the "Teekal Exemption". See Case C-15/13, *Technische Universität Hamburg v. Daten/otsen*, EU: C: 2014. See Article 12 of Directive 2014/24

III Obligations under Article 102, Treaty on the Functioning of the European Union (TFEU)

Statutory monopolies over infrastructure may have various obligations under Article 102, the most important of which are probably as outlined below. In any situation in which these issues seem likely to arise, they should probably be dealt with in advance in the conditions for the grant or maintenance of the monopoly, if they are not dealt with by sector-specific regulation.

- The monopolist should not "tie" the monopoly services to other services not covered by the monopoly. For example, it should not carry cars on a car ferry only if the passengers are staying in hotels owned by the company.
- If it has a monopoly of conventional car and passenger ferries, it should not use its control over eg a harbour to refuse access to means of transport not covered by its monopoly eg hovercraft or high speed passenger ferries.
- It should not make agreements or arrangements the effect of which would be to make it significantly more difficult for a competitor to tender for the monopoly right when the right comes up for renewal.
- It should not discriminate between companies using its services.
- It should not create or increase obstacles or difficulties for competitors, but has no duty to help them unless it is a monopoly and has committed an abuse, and a duty to give access or to help otherwise is the appropriate remedy for the abuse (Temple Lang, 2016).

Several questions arise from the issues outlined.

In the case of a monopoly said to be needed for financial or economic reasons, what precisely is needed in modern conditions, and why? Why would a State subsidy be less satisfactory?

When was the monopoly set up? Was the grant of monopoly ever the subject of competitive tendering? Should it be subject to competitive tendering now? Has the Member State a duty under Article 4(3) TEU to introduce some competition, at least into the selection of the monopolist?

If it is thought that a new monopoly is justified, for how long should it be granted, on what terms, how should it be regulated, and what obligations should be imposed? Is any State subsidy required, and if so, why? In particular, how should the prices or profits of the company be regulated?

What obligations, if any, may be imposed for reasons not based on the need to make a modest profit, but for example in the interests of the environment or the local communities in the areas served? For example, may the company be required to give preferential employment opportunities to individuals living in the local communities?

More fundamentally, if an enterprise has been developed over a long period to provide services to a community, is it possible and meaningful to put the service up to competitive tender at intervals, risking by implication the possibility that it will be awarded to another enterprise, and that the long-established enterprise will need to be wound up? This question is not resolved by saying, however truthfully, that an incumbent will always have legitimate advantages, and is likely to win a competitive tender. If an outsider has no real chance of succeeding against the incumbent, what would be the point of a competitive tender procedure? Would it be better to regulate the incumbent as far as is thought necessary, notwithstanding the risk of "regulatory capture" (the regulated enterprise acquiring undue influence over the regulatory authority)?

EU law allows Member States to establish Services of General Economic interest, and to ensure that they are not subject to EU competition rules insofar as those rules would obstruct the tasks imposed on them. This is, in effect, a form of regulation, which allows Member States to impose a wide variety of tasks and conditions, and to subsidise tasks insofar as they are loss making⁹.

IV Unintended consequences of competitive tendering for specific projects

It is said that competitive tendering can lead to loss of domestic employment and loss of strategic capacity. Both criticisms need to be addressed. In theory, to be comprehensive, a wide variety of different situations would need to be considered.

Competitive tendering cannot lead to loss of domestic employment if all the companies bidding are based (or are legitimately required to base themselves) in the region in question. Indeed, it is not competitive tendering, but successful companies from outside the region that may lead to loss of domestic employment. Companies can be selected if they offer "the most economically advantageous" solutions "from the point of view of the contracting authority", that is, the best value, even if they do not offer the lowest price¹⁰. This phrase should be interpreted to allow selection of the solution most advantageous for the locality or region, not merely the solution most advantageous financially for the license granter. Article 67 says that

⁹ Case C-280/00 *Altmark*, EU: C:2003:7747

¹⁰ Article 67 of Directive 2014/24: Article 82, Directive 2014/25

the "best price-quality ratioshall be assessed on the basis of criteria, including qualitative, environmental and/or social aspects, linked to the subject matter of the public contract in question".

Award criteria or contract conditions concerning the workforce to be used are legitimate. It would, for example, be normal practice to oblige companies tendering for public contracts to have non-discriminatory hiring policies. The criticism therefore is that sometimes the most economically advantageous solution may involve employment of labour from outside the region, when local residents could equally well have been employed. That may be so, but there would be no justification for saying that the effect on employment in the region may not be taken into account when choosing the most economically advantageous solution, including long term effects. This is so in particular where the overall object of the exercise is to benefit communities in less populated areas.

One requirement that might be explicitly adopted to obtain the most economically advantageous solution might legitimately be that it would employ residents of a less-populated and under-industrialised region as far as is reasonably possible. This might be criticised as protectionist, and undoubtedly requires careful drafting, since it could easily result in illegal discrimination in favour of the incumbent or in favour of local companies. However, it might well be reasonable and justified, depending on the circumstances. Other possible selection criteria or contract conditions would be to require the successful bidder to provide training for residents of the region, or to employ individuals who speak the local language, if it is a working language, or to use local sub-contractors as far as possible. The result of such an approach would probably be a negotiated arrangement: negotiated arrangements are envisaged by the Directive.

The most economically satisfactory solution should be assessed on a long term basis, and not only in the short term. Specifically, it may be appropriate to oblige the successful tenderer to invest substantial sums in improving the service or the infrastructure, and the result of this might be to contribute to employment in the region as well as improving the facilities for everybody.

"Loss of strategic capacity" would occur as a result of competitive tendering only if the contract awarded to a company outside the region was for such a long period that it became no longer possible for companies in the region to bid for the contract when it came up for renewal. If that were the result, the alternative would be that a solution that was not the most economically advantageous solution would be adopted on a permanent basis, for the sake of preserving indigenous strategic capacity that, *ex hypothesi*, was not initially able to offer that solution. There may in theory be such situations, but it is not easy to think of a

convincing example. If such a situation seemed likely to arise, the appropriate approach might be to invite tenders for partners in a joint venture with local or regional interests providing some of the strategic capacity that it is desired to maintain and develop. A local or regional cooperative should be able to mobilise whatever resources are available for such a purpose.

In other words, in both types of situation it would seem possible to use imagination to design an invitation to tender in such a way as to avoid or minimise the unintended consequences that are feared. It would be unjustified to conclude that the undesired consequences would inevitably be so serious and so unavoidable that no competitive tender should be arranged, and that therefore an inefficient incumbent monopoly or a high cost solution should be allowed to continue indefinitely. Discussions with companies that have expressed an interest, having been invited to do so, might be necessary to design the invitation to tender appropriately.

One suspects that some of the difficulties that have occurred in particular cases arose because the possible implications for local employment were not considered and provided for when the invitation to tender was being drafted, and were seen too late to be dealt with satisfactorily.

No amount of careful drafting can prevent situations arising in which the lowest price is offered by a company from outside the region, and the operations of the company in question may reduce employment in the region. Emphasis on the most economically advantageous solution overall, however, should allow the decision making body to choose the higher cost solution if that is thought appropriate.

But in any situation in which it is feared that competitive tender might lead to disruption of a community, or of a long established and reasonably efficient service, regulation as the alternative to competitive tendering should be considered. The relative merits of the two approaches would be a matter for judgment, and European law would not dictate the result.

V Competitive advantages and potential competition

If there is an incumbent providing substantially the service to be put up for competitive tender, in practice a reasonably efficient incumbent will almost always have significant and perfectly justifiable advantages over any competing outsider. On the other hand, if the service is entirely new and there is no incumbent, the arguments for competitive tender will be extremely strong. But even then it is legitimate to choose the most economically advantageous solution, provided that the invitation to tender is appropriately written, and not necessarily to choose the cheapest solution. If there is no incumbent, competitive tendering

cannot result in loss of domestic employment: at most, it could involve a missed opportunity to increase it, if suitable employees were available.

It is not unusual for a small local or regional company to be in competition with a larger company based outside the region. In such situations economies of scale and scope may be very important, and it is important, when writing the terms for the tender, to decide how much weight should be given to them. In general however scale economies are more likely to influence the lowest price rather than the most economically satisfactory solution.

All companies that are not exposed to competition have a tendency to become inefficient and to stagnate and fail to modernise. Even if the circumstances are such that the legitimate advantages of the incumbent make it likely that it will be selected in a competitive tendering process, the mere fact of having to reconsider and if necessary to redesign its service every few years should help to ensure that it gives appropriate weight to the interests and needs of consumers and users. An incumbent that knows that it must take part in a regular tendering process will be likely to pay more attention to the services being offered elsewhere by potential rivals, and should improve its own operations accordingly. Potential competition is often a more effective influence for improvement than regulatory supervision, and in any case they are not mutually exclusive.

It should also be remembered that if an incumbent is supervised or regulated in some way, there is always a risk of "regulatory capture", that is, the entity supposedly being supervised may obtain too much influence over the thinking of the body intended to supervise or regulate it. That risk should be significantly reduced if both parties know that a competitive tendering process will occur at regular intervals, provided that the final conditions of each tender are determined by an authority other than the supposed supervisor.

Value for money in public procurement is said to be based on economy, efficiency, and effectiveness. Economy and efficiency are self-explanatory and can be measured.

Effectiveness is more difficult to measure, for a range of reasons. First, we are making a judgement based on defined objectives, and there arises a question about whether such objectives are the "right" ones: has the organization targeted the most beneficial outputs and outcomes? Secondly, the ultimate outcomes for most public services are better lifestyles for individuals and healthier, better educated, better housed, more economically successful and more stable and cohesive communities as a whole. Judgements around these things are notoriously subjective, and often politically and culturally sensitive. (Arrowsmith, 2014)

This view is certainly correct, and several conclusions can be drawn from it. First, the authority that is defining the objectives of the project has a considerable latitude and discretion in defining them in the invitation to tender. However, it should be careful to define them clearly and explicitly. Second, if the authority's decision is challenged in court, the court should be slow to invalidate either the objectives stated in the invitation to tender or the decision finally arrived at by the awarding body. In other words, the court should not substitute its discretion for the discretion of the awarding body. Third, all the desired objectives may not be fully obtainable at the same time, and priorities may need to be decided, or compromises reached.

VI The 'most economically advantageous' solution for the community in question

A fourth conclusion seems reasonable. It is open to national legislatures, acting within the terms of the EU directives, to explain and elaborate by legislation the concept of the "most economically advantageous" solution, to make it more clear that it includes social and environmental objectives and advantages for the community in question as well as financial advantages for the taxpayer paying the bill. National legislation to clarify and confirm this may not be necessary, but it might be desirable, in order to promote flexibility and reduce uncertainty about the freedom of awarding authorities to promote their chosen objectives, and to avoid or minimise unintended consequences.

"Effectiveness" can mean both the success of the project in the light of its declared objectives, and the desirable effects of the way in which it is to be carried out. The invitation to tender can, if the awarding authority wishes, indicate how the work is to be done (although the authority should not tie the hands of the successful competitor so much that little scope is left for initiative and imagination).

These suggestions do not mean that the awarding authority can create a situation in which it is discriminating in favour of the incumbent or local firms: all arrangements of the kinds suggested would need to be carefully written and justified. They would therefore be more trouble to write, and probably more controversial to implement, than a simpler arrangement, or than regulation. The authority would therefore need to consider carefully whether the extra work was worthwhile.

VII Sector specific regulation

If the industry in question is a regulated industry, such as transport or telecommunications, the regulatory regime may provide protection for local or regional interests that it might be difficult to ensure by selection criteria or conditions in public contracts alone. In any case,

any invitation to tender must always be carefully integrated into the applicable regulatory regime. A regulatory approach may be more appropriate and more effective to achieve economic aims than trying to use public contracts alone. If the objectives are important, all available legal mechanisms should be considered, and used in combination if appropriate.

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