

Use of Screens to Prevent and Detect Abnormally Low Tenders (ALTs)

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Why worry about tenders that are too low? Auctions are supposed to procure at the *lowest possible price*, low tenders thus seem not only a natural *consequence of the competition* that auctions generate but also a desirable outcome for the procurer.

1. The problem and its causes

The problem

- Some bids may be *“too good to be true”*.
- What happens after the auction takes place is key to the overall outcome of the procurement process: the products or services specified in the auction have to be delivered with the quality or characteristics that were initially described, without renegotiation of the price and/or specifications, this is *not always the case* in practice.
- Some tenders may be too low as a result of the *uncertainty* involved in most contracts and the *asymmetric information* that naturally arises between the auctioneer and potential suppliers.

Causes Behind ALTs

1 Uncertainty

Large complex projects

Higher costs than expected

Ex-post adaptations during execution

Adverse selection: suppliers have more information than buyers. The winning bidder might not be the best, but the one that strategically anticipates what will happen after the auction and the one in the most favorable position to take advantage of ex-post negotiation conditions.

Moral hazard: the winning supplier (taking into account the procurer's switching cost) may exert less effort and fewer resources in raising the performance level.

Winners curse: the winner may be the most optimistic instead of the most efficient bidder.

2 Asymmetric Information

2. Tools to identify ALTs

How to identify ALTs in practice?

Screening bidders
(ex-ante or ex-post)

Establishing technical and financial qualification tests and requiring bidders submit evidence that they satisfy the specified conditions. i.e. **financial evaluation** and **guarantees** or insurance

1 Examining bids

Follow some pre-specified formula to set a lower bound on submitted bids. The bound could be formulated:

- Straightforwardly, **in terms of how low an acceptable bid can be.**
- In relation to the **expected provision cost** established by the procurer or in relation to a **price cap.**

2 Changing the auction format

Average-bid auction: the winning bid is the closest to the average of all bids submitted.

Effects in competition:

- It could provides weak incentives for bidders to strongly compete with one another.
- Makes it easier for bidders to reach and sustain a collusive agreement.

3. ALTs in IDB-financed Projects

MDBs mechanism to detect ALTs

- The WG has developed an arithmetical formula to identify tender prices which fall into the '**ALT risk-zone**' using a simple formula (assuming normal distribution of prices):

$$b^{alt} = b_m - \sigma$$

where:

b^{alt} = minimum bid to be considered acceptable

b_m = average bid

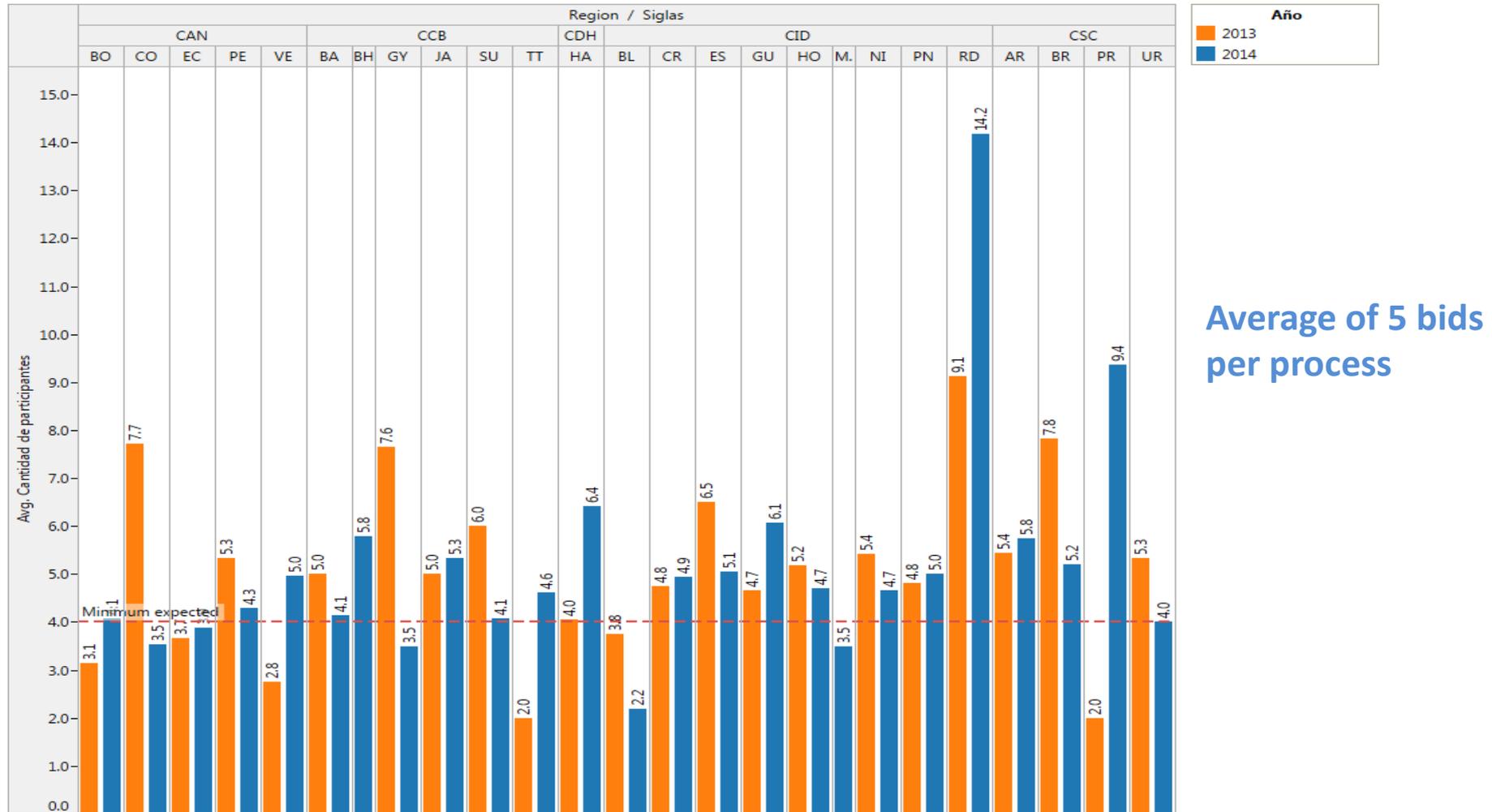
σ = standard deviation

- There will be a mandatory requirement for an Employer to undertake a detailed analysis of any tender which falls into the 'risk-zone', and which is subsequently recommended for contract award;
- The formula requires a **minimum of 5 tenders** to be meaningful;
- If there are 4 or less tenders all tenders shall be deemed to be in the 'risk-zone'.

No tender shall be automatically rejected at this stage, the sole purpose of this step is to identify which tender or tenders, if any, require further examination and clarification.

Average number of bids per process in IDB-financed projects

Competition 13-14



Source: Sample Indicator > \$200,000. SISCOR, IDB Docs, UNDP. CH reported no processes >\$200,000 in 2013 and 2014.

Empirical evidence

- **500 tenders** in **85 projects** in Argentina, Bolivia, Costa Rica, Ecuador, Guatemala, Honduras, Jamaica, Nicaragua, Paraguay, Peru and Uruguay.
- Contracts **since 2010** with a value of **at least US\$200,000**.
- Projects are in sectors such as health, education, agriculture and rural development, environment, energy, urban development and housing, water and sanitation and transport.

	Formula: $b^{alt} = b_m - \sigma$
Number of ALTs	76
Number of ALT winners	40
Percentage of auctions won by ALTs	47.1

- Considering the criterion suggested by the MDBs we would conclude that the problem of ALTs is significant in the sample.

Empirical evidence

		ALTs			
		1	2	3	4
Bidders	2	1			
	3	7	0		
	4	11	0	0	
	5	4	0	0	0
	6	7	3	0	0
	7	7	2	0	0
	8	3	2	0	0
	9	0	2	0	0
	10	1	2	1	0
	11	2	0	0	0
	12	2	0	0	0
	13	0	0	0	0
	14	0	0	0	0
	15	0	0	0	1
	16	0	0	0	0
	17	0	1	0	0

- In a total of **59** out of the **85** auctions there was at least one ALT.
- ALTs are a relevant issue also in terms of their presence **across auctions**.
- However, the study at this stage only considers incidence of ALT and not the actual **contract performance of suppliers that were awarded with an ALT**.

4. Conclusions

Conclusions

- It appears to be **counterintuitive** to select an auction format where the lowest bidder does not win. It could reduce competition, and generating competition is one of the main reasons why auctions are used in the first place.
- But it is clear that in some cases choosing an abnormally low bid might lead to **default/bankruptcy** by a supplier or to **contract cancellations**, which entail **costly project redefinitions** and **costly re-auctioning**.
- Procedures to identify ALTs should be used carefully. An adequate mechanism is to give detection rules the role of **alarm signals**. When a bid falls within the ALT category, financial and quality screening could be intensified. This is the case of the mechanism defined by the MDBs.
- However, if it is publicly known that such a criterion is used, and a low bid is likely to trigger closer examination of a supplier, **a reduction in competitive behavior could ensue**.

Conclusions

- This may be more relevant if, for example, financial screening and procurer protection are very costly to the supplier. But, unless this issue is dramatic, it seems that using a rule for this purpose could strike a **balance between competition reduction and doing away with dangerously low bids.**

