

Public Procurement System Market Study

by Fiscalía Nacional Económica of Chile

I. Introduction

The following document is a summary of the public procurement system market study conducted by the Market Study Division of the Chilean competition agency, *Fiscalía Nacional Económica* (or “FNE”).¹ This study was initiated in May 2019 and the final report was submitted in November 2020.²

The study focused on purchases made through a centralized electronic buying platform (and database derived thereof) which is administered by a government agency named *Dirección de Compras y Contratación Pública* (or “ChileCompra”). Most government purchases are made through this platform with notable exceptions such as defense goods and contracts, and large public works and infrastructure.

The Chilean government spends around \$10 billion dollars each year on public procurement, which in turn represents almost one-third of total government expenditure. Therefore, it is not an exaggeration to say that public procurement has a significant impact on the delivery of public services in Chile. Either *directly*, by means of providing infrastructure, healthcare services or educational facilities, for example; or *indirectly*, that is by means of generating business opportunities for the private sector.

Purchases are made through three main procurement mechanisms: (i) public tenders, (ii) framework agreements, and (iii) direct awards. Public tenders represent around 55% of the purchases in value, framework agreements about 25% and direct awards the remaining 20%. These mechanisms are used in a predetermined manner. As a general rule, if a certain product is in a framework agreement, it should be bought there. If it is not and there a legal rule that enables the use of a direct award, this mechanism can be used. Finally, public tenders are the last option.

II. Methodology

Our market study attempted to cover all government purchases spanning over a period of three years, from January 2017 to December 2019.

¹ Chile’s Market Studies Division is a recent creation. Following a set of OECD recommendations, the Division was created by government decree in 2016 and equipped with unique powers. Our most relevant tool is the ability to collect data from private parties, even forcefully. Importantly, beyond a more accurate description of a given sector, this power has allowed us to formulate evidence based public policies, which have been key products of our studies. To date this Division has concluded five market studies and made several recommendations to government and parliament—many of which have become law.

² The full final report in spanish can be found here:

<https://www.fne.gob.cl/wp-content/uploads/2020/11/Informe-Final-EM05.pdf>

Our main source of data collection was the ChileCompra database. The initial intention was to use the whole database to complete a series of analysis of the competitive performance of the entire system, and to assess how each of the three main acquiring mechanisms were working. Nevertheless, after going through this data for weeks, we realized that this repository was not useful by itself for the purposes of competition analysis. Crucial information was missing. The database lacked any detail about relevant aspects of public tendering processes, such as: (i) the number of bidding participants, and (ii) the score they obtained or the price they offered. In some cases, this information was present but, unfortunately, only in scanned versions or non-standardized documents, which made it almost impossible to process them automatically.

For this reason, we were not able to use the ChileCompra database directly to perform competition analysis of the different acquisition mechanisms. We had to complement it with more information. In concrete, what we did was to manually analyze the documents of a random sample of 1,200 purchasing processes, divided into three different categories of 400 each: public tenders, framework agreement lines and direct awards. We built a new database with this manually extracted data. This randomized sample was representative of the whole population and we were able to make valid inferences with a 95% confidence level.

In addition to this, we conducted a survey to public buyers. This survey was sent to 600 public institutions, including government purchasers and municipalities. The purpose of this survey was to have more information regarding matters such as the structure of the public procurement departments, how well trained that staff was, their salary, and how they planned and handled the procurement processes.

Finally, we also performed a comprehensive review of all existing literature and regulation about public procurement in Chile.

III. Main findings

Using the information gathered, we performed a series of empirical and regulatory analysis from a competition point of view. We present the main findings and takeaways on the main parts of the study, divided by the following topics: (a) public tenders; (b) framework agreements; (c) direct awards; and (d) planning and budgeting.

(a) Public tenders

Public tenders are where competition should work at its fullest and given the fact that around 55% of funds are spent through this mechanism, this should have been good news. Nevertheless, one first very salient and worrying fact was that in most tender processes only a small number of suppliers took part in the process. Indeed, in 25% of these tenders there was only one bidder, and in 55% of them there were three or less.

Regarding the cause of this low turnout on public tenders, we provide a series of hypothesis based on the information gathered. One of the reasons we believe causes

this, is that the tender specifications have anticompetitive provisions. A review of 400 tender specifications showed that in 20% of them there were direct limitations on competition. The most typical one being requesting a particular brand in a product or service. But there were other limitations, such as conferring a remarkably high score to a rather vague item like *quality*, without specifying some guidelines as to how it should be measured or what it means. This circumstance meant that a very decisive aspect of the tender process depended on a very discretionary criterion.

Another shortcoming in Chilean public procurement procedures was the lack of standardization. Each public body usually made its own specifications from scratch, with quite different structures, length, weighting criteria, and calculation formulas. This is inefficient because it means that a great deal of available public resources is spent on creating new bidding documents every time a tender is called. And, on the side of the bidder, this lack of uniformity amounts to plenty of time spent understanding each tender in every new occasion, which may be a barrier to entry in the market.

A further aspect of concern was the significant number of public tenders that were not even manually analyzable. 8% of the tenders reviewed in the public database did not have all the necessary documents. For instance, they lacked the tender specifications, the award record, or the evaluation report. This situation is worrying, because it may cause negative impact regarding integrity and transparency in public procurement, and potentially less competitors.

Finally, 20% of the public tenders we analyzed contained contradictions between the information registered by public officials in the public database and the documents. In other words, in one out of five tenders the data registered in ChileCompra's public database simply did not match with the information scanned. So, for instance, while the database specified one company as bidder, the scanned procurement contract mentioned a completely different bidder. This is a further worry as this lack of transparency, and potential integrity problems could also be causing less companies to participate.

(b) Framework agreements

Framework agreements are carried out by Chile's Procurement Agency with the purpose of ensuring a continuous supply of goods and services to the public entities. This mechanism reduces duplication of administrative costs and increases the government's purchasing power. By employing the framework agreement, the public body seeks to avoid carrying out a new tender process every time a good or service is needed.

In theory, this process comprises two stages. In the first stage there is a pre-qualification of potential contractors by a competitive procurement method, whilst the second involves selecting and contracting (from those that went through the first stage). Suppliers will be ranked, usually, in a cascading order, and thus whenever the first supplier runs short of stock, then the second one comes into play, and so on.

An analysis of how these framework agreements are functioning in Chile shows that they are not working in a competitive manner. There is little or no competition on the

first stage, as on average around 80% of those suppliers that apply go through to the second stage. The large percentage of qualified bidders within the agreement means that no one is guaranteed to receive purchase orders, and therefore nobody offers competitive prices, that is, prices close to their marginal costs. Regarding the second stage, there are no clear rules, so any entity could pick any supplier -notwithstanding, for example, a higher price- and this was a further reason that explains the lack of a first competitive stage. Thus, the framework agreement mechanism, which is the mechanism used for most of the transactions in the public sector (not the majority of funds), operates as a de facto direct award mechanism.

Other structural problems were also identified that hindered competition. For instance, many framework agreements presented design flaws which favored competition between distributors of certain brands and not between brands or producers. But the important competition in public tendering is that between brands or producers, and not distributors. It is very usual to find in these framework agreements that public officials call for tenders on specific products from particular brands (e.g., 1 liter of whole milk from brand A), and not on specific products from any brand (just 1 liter of whole milk), so that the cheapest alternative wins.

To assess how relevant the design problems were, we calculated the inefficiency caused by designing tender processes by brands (not standardized products), and for not having a rule that made it mandatory to pick the most economical alternative. For this we randomly picked 400 products within the framework agreement catalogue and redefined relevant markets in a conservative manner. Following on with the milk example, on the catalogue you can currently find there is a product called “1 liter of whole milk Brand A” for which there are 4 distributors, and a product called “1 liter of whole milk Brand B” for which there are 3 distributors. We put all of these under a new category called “1 liter of whole milk” for which there were 7 distributors. We say this was conservative because we could have possibly included other milks within the relevant market (2%, skimmed, etc), but we did not.

Using those new relevant markets, we calculated -from real transactions- the difference between the actual choices made by public buyers and what was the cheapest distributor price from the cheapest substitute product. We did this for the abovementioned 400 markets. Our results show that just by buying in this manner, the state could have saving for at least USD 240 million and up to USD 805 million, per year. This is, only for having well designed markets and a rule to select providers in the second stage.

(c) Direct awards

Direct awards allow contracting authorities to negotiate directly with potential contractors. The use of this mechanism is limited to special circumstances set in the Public Procurement Regulation and which usually refer to reasons of urgency. This is by definition a non-competitive mechanism that should be used in exceptional circumstances, but which accounts for 20% of funds spent on.

We examined all the documentation of 400 direct awards from different public entities, one by one, in order to assess whether they were correctly executed according to the government purchases regulation. With a rather lax yardstick -regarding the legal fulfillment of the use of the mechanism-, we concluded that 58% of them were not sufficiently justified according to the legal and regulatory framework.

(d) Planning and budgeting

Another relevant yet usually looked over issue from a competitive perspective in public procurement is the planning and budgeting stage. This the preparatory phase of a procurement procedure and it aims to design a robust process for delivering the required works, services or supplies. It is by far the most crucial stage of the procedure because any decisions made during this phase will impact and possibly shape the success -and competitiveness- of the of the whole purchasing cycle.

If the planification is done with time, there is sufficient time to fully explore alternative procurement approaches, such as joint bidding with other organizations, and if it is done correctly, the public body will better understand and define the relevant market it will face.

Like every purchaser, public entities can choose different markets to satisfy a need, and those markets can be more or less competitive. For example, a public institution requiring a computer might pick different markets according to the choice: it can buy the computers, lease them, or upgrade the ones it already has. Depending on geographical qualities each of these markets may have more or less bidders, and therefore -possibly- better or worse prices.

Notwithstanding the importance of this issue, procurement plans are not mandatory in Chile, and although they formally exist in the law, there are no mechanisms for monitoring its compliance.

In brief, we concluded that this phase of public procurement is not sufficiently developed in Chile, so our first recommendations were in this direction.

IV. Public policy recommendations

As it was summarized above, we found serious competition problems in all the purchasing mechanisms used in Chile, which in the agency's view could only be fixed by a large structural change. Some of the main proposals are the following:

- (1) ChileCompra, Chile's Procurement Agency, only regulates by soft law. Its guidelines and instructions are not mandatory nor enforceable for to the public entities. It does not even have the power to instruct how the databases for tendering processes must be fulfilled. The FNE believes and proposed that ChileCompra should have enforceable regulatory powers.

- (2) Having clear-cut, processable data in our public databases is a critical tool for the Competition Agency, in order, for example, to better detect bid rigging cases. As such we proposed that the public procurement database should be fully digital, and by this we mean consisting only of processable digital documents.
- (3) Furthermore, we see that the sanctions for noncompliance with the regulation in Chile are not really dissuasive, as evidenced by the fact that 58% of the direct awards are poorly justified. This fact tells us that there is no fear among public purchasers of not complying with the regulatory framework. We propose to elevate sanctions and give powers to a body to apply them in a fast manner.
- (4) We also propose that there must be one structured and mandatory planning phase for all public entities. In other words, all public entities should plan in advance their purchases.
- (5) Regarding bidding processes, we propose that all efforts are made to attract more competitors, This entails, at least, that a correct demand analysis in order to have certainty about what are the players and main characteristics of each competitive markets and that processes should be completely standardized
- (6) As to framework agreements, we propose to actually make them competitive -as they should be-, so this entails having a competitive pre-qualifying stage in which few applicants win, and a predetermined award rule should be introduced in the call-off stage.

V. Conclusions and first impacts

This market study was the first of its nature in Chile to analyze the public procurement system from a competitive lens, including not only how it was working but whether the rules were in itself pro-competitive or not. Our main conclusion is that even though Chile has a good public procurement system, where all transactions are recorded centrally, there is plenty to perfect to make it a more competitive and efficient system.

A preliminary draft of this study was published on the 25th of August of 2020, and on the next day the Minister of Finance announced a legal reform to amend the public procurement system taking as a guide the FNE's market study.³ This bill was introduced to Congress on March 30th, 2021 and in fact considers most of the FNE's proposals.⁴

Furthermore, ChileCompra implemented some of the recommendations that did not require a law in a recent bidding process for a software framework agreement. They

³ See: <https://www.df.cl/noticias/economia-y-politica/actualidad/hacienda-anuncia-envio-de-proyecto-de-ley-para-modernizar-el-sistema-de/2020-08-27/125056.html>

⁴ See: <https://www.chilecompra.cl/2021/03/hacienda-envia-proyecto-de-ley-de-compras-publicas-para-generar-mas-transparencia-y-competencia-en-las-transacciones-que-realiza-el-estado/> and <https://www.df.cl/noticias/economia-y-politica/gobierno/proyecto-de-ley-que-moderniza-las-compras-publicas-obligara-a/2021-03-30/074728.html>

made a competitive first stage process where only one provider was selected, and the result was quite impressive and they secured, for example, a 65% discount in Microsoft Office when compared to the previous framework agreement.⁵

⁵ See: <https://www.chilecompra.cl/2021/03/chilecompra-obtiene-mayor-competencia-y-precios-65-mas-bajos-en-sofware-de-oficina-para-el-estado/>