Public sector ICT purchasing – can competition law help fix it?

July 2013

Speed Read

Competition law overlaps with, but extends beyond, competitive public sector procurement, for it encourages competition and innovation, including in the longer term (and current public sector procurement practice can be poor for long term outcomes). Strong action last week by the UK competition regulator, the Office of Fair Trading (OFT), around public sector ICT market failures points the way to:

- possible competition law (Commerce Act) issues in NZ (a topic rarely raised in this context);
- exposure to litigation including for the public sector;
- a way of solving market problems that aren't solved by current procurement practices (in fact, they can be made worse by those practices);
- just as the UK regulator is helping solve problems in the public sector, so can the Commerce Commission;
- dealing with problems and solutions for other goods and services bought by the public sector.

Competition law reinforces the need to take a strategic approach to procurement, having regard to balancing the positive and negative market impacts of features such as those bullet pointed at the end of this Speed Read introduction.

Despite some improvements, many ICT suppliers still have considerable disquiet about the way the public sector makes its choices around its huge spend on ICT (but our experience is that they usually won't complain for fear of being informally blacklisted). If they are right, then the public sector is losing out, as is, ultimately, NZ Inc, as to pricing and as to innovative services.

As well as high profile failures pointing to problems, there are concerns about NZ suppliers being unable to compete with off-shore providers, concerns from open source providers and so on.

Competition law, in the context of ICT public sector procurement, has a valuable focus that includes dealing with high barriers to enter the market caused by such things as:

- market concentration in a small number of players;
- bundling of services;
- vendor lock-in due to lack of inter-operability;
- the negative effects of framework agreements (which are increasingly used by the public sector);
- combined purchasing by or for multiple agencies (the All of Government contracts being a high profile example, and it's an example too of framework agreements).

Applying competition law and policy principles can be a powerful adjunct to best practice public sector procurement. And it can help overcome a common failing in the way that public sector procurement is done, despite what best practice requires of it. In practice, procurement focusses on short term objectives, such as the term of the contract, to the detriment of long term objectives.

Given that public sector procurement has minimal external oversight in NZ, compared to the UK, and that leads to substantial problems in NZ, competition law has a more important role in NZ.

What is the OFT doing?

With some differences, UK competition law overlaps with our Commerce Act. For some years the OFT has increasingly focussed on market failure in public sector procurement. For example, in 2011, it did a useful detailed report[1] on the topic, which is a valuable resource also for New Zealand.

In that context, the OFT last week noted ICT issues such as the concentration of most of the ICT services into a small number of suppliers, leading to sub-optimal outcomes.

So it is seeking input[2] from stakeholders including suppliers and public sector agencies to enable it to assess market conditions in ICT public sector procurement. The OFT will then look at options including:

- a full market study;
- initiating competition enforcement proceedings (that can include "*full enforcement action against public bodies where we have evidence of abuse of market power or anti-competitive agreements*";[3] and
- Seeking voluntary action from industry and/ or public sector buyers.[4]

Public sector Commerce Act compliance

NZ Public sector agencies also have Commerce Act obligations, save that some activity is only within the Act, particularly as to central Government, where the agency is acting "*in trade*".[5] So both the public sector and the supplier community have Commerce Act obligations.

Why is competition law particularly important for NZ public sector procurement?

Given its smaller size, NZ is more likely to have market failure problems in ICT public sector purchasing than the UK. So the UK insights are valuable, and "*ring a bell*" in relation to many features of the NZ market.

There is a particularly significant additional reason why the Commerce Act will be more important in NZ: the ability to have external legal review of public sector procurement is far lower than it is under the UK's EU-derived public sector procurement regime. Cases where there can be judicial review in New Zealand are rare, as the few cases show, and most suppliers fail in those cases. That is not surprising: in our experience, even quite egregious transgressions are not reviewable due to the way the courts have evolved the judicial review remedy as to procurement. So, judicial review is close to ineffectual at present. Other avenues, such as Auditor-General review, have only a limited role (for example, the Auditor-General does not directly seek rectification of a failure: it just reports on that failure.

All that combines to have a situation where public sector procurement has decidedly light external overview, and that produces poor processes and poor outcomes. There have been improvements over recent years, but there are still poor outcomes for vendors, the public sector and ultimately for Kiwis.

So, if competition law can help plug this gap, it is valuable, imperfect though competition law is.

Barriers to entry and expansion

A fundamental competition law concept is that of barriers to entry (and expansion). To the extent that it is too hard for a new player to enter the market, or for an existing player to expand, there is often market failure. As the OFT CEO said in May, with comments also applicable to NZ:[6]

> *Barriers to entry and expansion lie behind many problems of competition in public markets. Entry barriers can often arise from the way in which government procures and commissions services. Two-thirds of commissioners [that is, public sector agencies acquiring goods and services], providers and regulators we surveyed in 2011 thought there were significant barriers to entry in public markets.*
>
> *Long and complex bidding processes create entry barriers by increasing costs. They disproportionately favour large suppliers and incumbents. Equally, requirements for tenderers to have extensive experience in the market favour incumbents and rule out new and innovative businesses.*
>
> *Sustained barriers to entry and exit or initial market design can be both causes of public markets being concentrated in the hands of a few providers. Concentration in public markets means reduced choice for commissioners or users and reduced competitive pressure on providers. It may also increase the risks to continuity of service.*
>
> *The OFT sees risks ahead about the concentration of some public service markets. We are concerned when we see concentration that suggests that, in practice, markets are only contestable by established incumbents. It is then a short step for those incumbents not to compete with each other. When they explicitly agree not to compete, we can pursue them under competition law. But tacit collusion – where each firm has a niche and does not challenge outside that area – is something that competition authorities have real difficulty tackling , and which is better considered through procurement, commissioning and market design.*

Balancing complex factors

The 2011 OFT report however highlights the need to weigh up the factors, for and against. For example, while complex procurement processes (to enable strong comparison of apples with apples, etc), and the requirement to have prior experience, have their benefits, they also have downsides.

For those involved in public sector supply and procurement, reading of the OFT documents is recommended. The approach overlaps with standard procurement principles (not surprisingly as both are underpinned by competition).

We now summarise some of the points in those documents:

***"Tacit collusion"*: 2 or 3 competitors not really competing**

High barriers to entry can cause excessive market concentration, leading to market failure:[7]

Conditions enabling "*Tacit collusion*", or "*coordinated effects*", using the competition law lingo, are a strong feature of a number of markets in which public sector agencies buy ICT goods and services. Suppliers don't have to be in a smoky room fixing the price for there to be problems: if there are only two or three of them, often there is no benefit in shooting themselves in the foot by competing down the price. Similarly the incentives to offer better and innovative services evaporate too. That is why – as economists recognise - many duopolies fail to achieve great market outcomes as their incentives to compete are restrained.

High quality public sector procurement can go a long way to sort this out (although challenges will remain). But current practice often fails in that regard, with many RFP processes **facilitating** tacit collusion/coordinated effects, where there are few suppliers in the market.

Interoperability and the barriers to switching suppliers

Being locked into proprietary ICT systems is increasingly seen, under competition policy, as a major source of market failure. This could involve inter-operability of systems[8] so that data and processes cannot be readily transferred onto new systems. It could involve high costs of switching suppliers, such as the costs of transferring and of restrictive licence agreements, etc. It could involve the difficulty of switching suppliers due to the perceived risk of disruption of services. It could include locking in customers under long term contracts which are costly to terminate early.

For example, unless care is taken by buyers, cloud computing, based on proprietary systems, can lead to re-monopolisation in markets that have seen greater competition emerge. Cloud computing providers can lock in their customers.

This area should be a key focus of public sector agencies: if locked into a system, competition down the track will be reduced or eliminated. But this often gets scant or no attention in procurement design. And that segueys into the next topic; the importance of considering the long term.

Long term competition and innovation

Interoperability and barriers to switching suppliers are an example of a key focus of competition law where public sector procurement practice often fails, due to design and strategic failure. The competition law focus is also on competition and innovation in the long term. An RFP process may lead to good short term outcomes (for the term of the contract) but then leave long term problems, as competitors exit the market and/or as it becomes hard to switch suppliers at the end of the term.

Barriers to exit

There can be high "*barriers to exit*" as well, leading to market failure. OFT has emphasised this: the public sector agency ends up being stuck with low grade and inefficient services down the track as it can't pull out of taking those services. Transitioning to a better provider is just too hard. That is a commonplace problem:[9]

> *Barriers to exit can be equally harmful to competition. When poor or inefficient suppliers are prevented from exiting a market it can significantly undermine incentives for rivals to compete for market share.*
>
> *The need to ensure continuity of service, for example in the provision of schools and hospitals, can be an important source of barriers to exit. As noted in our report on Orderly Exit, competition involving a diversity of suppliers is one of the best ways of ensuring continuity of service by having a number of alternative providers that can take over from a failing provider. Continuity regimes, where needed, should focus on mitigating the impact of exit rather the mitigating the risk of exit. If public markets are being opened up to competition, a credible risk of exit – albeit potentially having a different meaning to that in some other markets – is an important dimension. Decisions in the health sector to allow trusts to go into administration, whilst safeguarding services to patients, should be seen in this context.*

All this points to a broader strategic approach at the design phase, something on which, while the public sector is better, it has a long way to go. What the OFT says above is decidedly foreign to the way we've often seen procurement handled.

Bundling of services

This is a common problem in NZ: while there are efficiencies in bundling different types of services, this can lead to market failure where only limited numbers of suppliers can provide one part of the bundle so that only they can effectively bid to supply the full bundle (when multiple suppliers could create strong competition for the other parts of the bundle).

Aggregation of contracts

This is the All of Government scenario where only a few suppliers are chosen to service a market. For example, this can act "as *a barrier to entry for smaller suppliers that don't have the capacity to deliver the aggregated output*".[10]

Framework agreements

These are also increasingly being used in public sector procurement, a high profile example also being All of Government contracts. As the OFT ICT Call for Information says:[11]

> *Framework agreements undermin[e] competition on price by facilitating suppliers coordinating bids (for example by restricting the number of firms that can win contracts) or deterring suppliers from joining because of the up-front costs involved in joining a framework.*

Flawed assumptions on the benefits of aggregated procurement and framework agreements

Government promotes the claimed cost savings of such ICT aggregated and framework agreements (reporting the millions per year saved). But past experience shows that Government is unlikely to have factored in the wider financial implications of such agreements, including long term implications. The focus is likely to be on the short to medium term when, overall, there may in fact be considerable losses as a result, including not just as to perceived cost saving, but also lost net financial and other benefits due to lost improving and increasingly efficient services.

Yes there are real benefits, but the negatives often are not assessed on a sufficiently robust cost benefit analysis. A competition policy and law focus would be valuable in getting the best outcomes.

Balance is critical

For each of the negatives above there are flip side benefits. After all, it is not good enough for smaller NZ suppliers to say just "*Buy NZ*" in relation to ICT services,[12] when the international supplier with heavily tested and developed services may have the better and most reliable solution: there are plenty of examples where going with the smaller local provider has ended in tears. Suppliers and public sector agencies must realistically address this.

And there are benefits in bundled supply of services, in framework agreements, in aggregated purchasing, etc. But what is the net position? How do the negatives stake against the positives in terms of cost and benefit.

As to balance in approach, the OFT says in its 2011 report:[13]

> *By taking due account of these four themes at the early stages, commissioners and procurers can better engage in balancing some of the evident complex trade-offs involved in commissioning and procurement decisions around the delivery of public services. These trade-offs can include:*
>
> - ***the choice between local or centralised procurement*** *- some services may be more amenable than others to being procured locally, however, there may be less scope for local procurement exercises to then, for example, secure volume discounts*
> - ***the choice between large and small contracts*** *– joint procurement projects and the bundling of different service contracts may lead to significant, valuable economies of scale and scope and reduce administrative burdens, but may also reduce the ability of smaller suppliers to participate, and*
> - ***the choice between short-term and the long-term*** *- there may be strong imperatives to make short-term cost savings through the choice of certain types of contracts and suppliers, but an excessive focus on short-term cost savings may be at the expense of creating dynamic markets over the long-term that are open, contestable and create the right incentives on suppliers to achieve and secure value for money.*
>
> *1.29 It is vital to recognise that the focus and competency with which commissioners and procurers balance each trade-off will significantly influence outcomes across public service markets. Focusing solely on achieving the lowest possible tender price today, may lead to a narrow supplier base tomorrow with reduced incentives to improve quality and innovate, making it harder to achieve value for money in the long term and ultimately result in reduced economic growth.*

What might happen if nothing is done?

Disaffected suppliers might end up taking legal action. Or the Commerce Commission might do so, possibly encouraged by suppliers who have seen a possible breach of the Commerce Act.

If the Commission does take steps – in our view it should as it has a strong potential role to help the public sector, suppliers and NZ Inc. – it might follow the OFT path: start by seeking market information, educating the market, encouraging compliance, and only then take enforcement action. That may be so unless the breach is so egregious that earlier legal action is appropriate.

In this article we haven't attempted to unpick the ways in which the various competition law and policy issues apply, as that varies depending on the scenario. Some of the matters above are more likely to lead to competition law breach than others.

---

1. http://www.oft.gov.uk/shared_oft/reports/comp_policy/OFT1314.pdf

2. http://www.oft.gov.uk/shared_oft/markets-work/ict-cfi.pdf

3. *'Competition in Public Services'*, Page 12, http://www.oft.gov.uk/shared_oft/speeches/2013/06-13_Competition_in_public1.pdf

4. http://www.oft.gov.uk/shared_oft/speeches/2013/06-13_Competition_in_public1.pdf

5. The Act only binds the Crown in so far as the Crown engages in trade, which at least excludes Crown action where the Crown is acting in a regulatory role (s5 Commerce Act and also *Glaxo New Zealand v Attorney-General* [1991] 3 NZLR 129). Additionally, the Act applies to *"every body corporate that is an instrument of the Crown in respect of the Government of New Zealand engaged in trade."* (s6 Commerce Act). There are definitional issues around the distinction between Crown and Crown corporate body in respect of the Act. So, the Act applies in differing ways to, for example, Government Departments, and to DHBs, SOEs, CRIs, etc.

6. '*Competition in Public Services*' Page 8, http://www.oft.gov.uk/shared_oft/speeches/2013/06-13_Competition_in_public1.pdf

7. '*Competition in Public Services'* Page 10, http://www.oft.gov.uk/shared_oft/speeches/2013/06-13_Competition_in_public1.pdf

8. Coincidentally, the EU produced, on 26 June, some guidelines for managing inter-operability in a procurement context.

9. '*Competition in Public Services*' Page 9-10, http://www.oft.gov.uk/shared_oft/speeches/2013/06-13_Competition_in_public1.pdf

10. '*Call for information on the supply of Information and Communications Technology to the public sector*', Page 3, http://www.oft.gov.uk/shared_oft/markets-work/ict-cfi.pdf

11. '*Call for information on the supply of Information and Communications Technology to the public sector*', Page 3, http://www.oft.gov.uk/shared_oft/markets-work/ict-cfi.pdf

12. Leaving aside free trade agreement obligations for the present

13. Page 11, http://www.oft.gov.uk/shared_oft/reports/comp_policy/OFT1314.pdf

---

We welcome your feedback on this article and any enquiries in relation to its contents. This article is intended to provide a summary of the material covered and does not constitute legal advice. We can provide specialist legal advice on the full range of matters contained in this article.

Wigley+Company
PO Box 10842
Level7/107 Customhouse Quay, Wellington
T +64(4) 472 3023 E info@wigleylaw.com
and in Auckland
T +64(9) 307 5957
www.wigleylaw.com