

**SHALL PUBLIC ENTITIES BE OBLIGED OR FREE TO BUY
THROUGH A CENTRAL PROCUREMENT AGENCY?
SOME INSIGHTS**

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ABSTRACT. Centralization of public procurement is capturing the interest of governments and organizations. Indeed, new central procurement agencies are going to be set up at central and local level, with the objective of obtaining value for money and resources for social spending. In pursuing such a goal, the first important strategic decision for the government, is to choose between public entities forced to join the system or not. In this paper two different scenarios for a Central Procurement Agency awarding framework contracts are compared. In the first case, public entities buy products and services provided by the Agency on a voluntary basis, while in the second model they are obliged to join the system. As a results, a different level of certainty about the demand to be satisfied is guaranteed to suppliers competing for the contract. What emerges is that, in the short run, when a central procurement agency is established where there was not, the government shall impose to Public entities to buy the products auctioned by the Agency. In contrast, in the medium-long run, it is strategic to let entities free to join the procurement agency's initiatives.

INTRODUCTION

In recent years Centralization of Public Procurement has become extremely popular in Europe.¹ This statement is demonstrated by the fact that several Countries established a Centralized Procurement Agency in the last two decades: SKI (Denmark), OGCbuyingsolutions (UK),

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Consip (Italy), and BBG (Austria).² In addition, within each national framework, public purchases have been centralized at local level too. A recent example of this tendency is provided by the Italian Financial Act 2007,³ allowing each Region within the country the opportunity of setting up its own Central Procurement Agency.⁴ Indeed, in 2007 new experiences of Centralization have been observed.

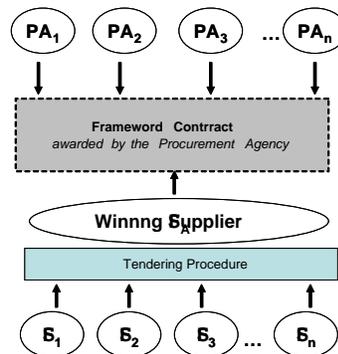
This article offers some preliminary considerations that could facilitate the Governments, either at National or local level, to solve the strategic “dilemma” of forcing or not the Public Entities to buying products provided by suppliers selected by a Central Procurement Agency (on a regional or central basis). The paper is organized as follows: section 1 demonstrates the parallelism between a Central Procurement Agency and a platform operating in two-sided markets and it introduces the financing model adopted by the Government at the start-up phase of the Central Procurement Agency; after defining the players of the model, the paper illustrates, in section 2, the scenario in which Public Entities are free to join the platform when a Central Procurement Agency is set up. A comparison with the Public Entities obliged by the Government to buy from the Procurement agency is then given. Section 3 provides some insights about the Central Procurement Agency working in the medium-long run. Concluding remarks are in section 4.

CENTRAL PROCUREMENT AGENCIES AS PLAFORMS

The typical mission of a Central Procurement Agency is to bundle the needs of public entities, namely goods and services, in order to award a “Framework Contract” through a competitive tendering procedure. The best supplier is then selected among those willing to submit an offer for that Contract. When the Framework Contract is signed and until his expiration date, Public Entities have the opportunity of buying the products and services from the selected supplier (Figure 1).

In this context it is of crucial importance to introduce the concepts of “two-sided market” and “platforms”: “the concept of two-sided markets refers to situations where one or several competing “platforms” provide services that are used by two types of trading partners to interact and operate an exchange.”⁵

FIGURE 1
Central Procurement Agency as a Platform



Indeed, a Central Procurement Agency is considered a platform, since it **enhances** the interaction between sellers (suppliers making an offer for signing the framework contract) and buyers (Public Entities satisfying their needs through products and services offered by the selected suppliers).

The literature says that, in order to survive, a platform must get “*the two sides on board*”, since the population of one side strictly influences the population of the other one, and vice versa. In addition, it is not only important to reach a good level of participation - number of registered users - but also a good level of “activity” - the registered users made transactions through the platform.

In this phase “*the chicken&egg problem*”⁶ becomes relevant: when a platform is established for the first time, which side of the market shall be get on board firstly? Public Entities or suppliers?

In the concrete case of a Central Procurement Agency, suppliers will submit an offer to the first competitive tendering procedure aimed at awarding a contract, if and only if they expect a sufficient level of revenues from the Public Entities that will buy through the contract; on the other hand, Public Entities, once the contract is signed, are likely to buy from the winning supplier, only if he offers products/services at a price and/or level of quality competitive with respect to the private market.

By definition, suppliers can not be obliged to submit an offer in a tendering procedure, but, once the contract is awarded the winner of the competitive tendering procedure has to satisfy any Public Entity joining the platform. Indeed, on boarding of suppliers can not be imposed, and the strategic decision for the Government is restricted to Public Entities.

Before making any assumption, let fine-tune the definition of the players within the model, as well as the financing model that will be adopted when describing the two scenarios.

- 1) The Government, choosing to Centralize within its region the public expenditure through a Central Procurement Agency.
- 2) The Central Procurement Agency is usually a public entity which main aim is to bundle public demand and to award public tenders in order to select the best supplier/s combined with offering the higher quality at the lower price. The Central Procurement Agency represents the platform of the market, awarding Framework Contracts⁷ to the best supplier that will be used by several Public Entities. The success of the Central Procurement Agency is based upon the level of transactions it generates through the Framework Contracts, that are strictly connected with the quality and the price offered (i.e. best market conditions).
- 3) The Public Entities they buy products and services in order to satisfy their needs. They can be split into two different groups:
 - a) “first class” Public Entities – they respect terms of payments;
 - b) “lazy” Public Entities – they do not respect terms of payments.
- 4) The Suppliers they provide goods and services. They participate to the tendering procedures managed by the Central Procurement Agency by submitting an offer for winning the competition. Suppliers can be split into two different sets:
 - a) efficient suppliers – they offer the best quality of products services at lower prices
 - b) inefficient suppliers – poor levels of quality at uncompetitive prices

The Financial Model

“Two-sided markets are roughly defined as markets in which one or several platforms enable interactions between end-users, and try to get the two (or multiple) sides “on board” by **appropriately charging each side.**”⁸ In our scenarios we assume first that the Central Procurement Agency is fully financed by the Government, and the end-users (the suppliers and the Public Entities) that network through the platform are not charged (e.g. there is not a registration fee, a transaction fee, etc.).

SHORT RUN – COMPARING TWO SCENARIOS

Let assume first that, in the short run, when the Government establishes a Central Procurement Agency, the Public Entities do not have any imposition (First Scenario); secondly let see what happens if the Public Entities are forced to join the system (Second Scenario).

First Scenario: The Government Lets Public Entities Free to Join the Platform

In this model, the government that sets up the Procurement Agency lets the Public Entities free to buy products and services provided by the Agency on a voluntary basis. What emerges is that this mechanism may generate a virtuous or a vicious cycle.

Virtuous Cycle

If the suppliers trust on the efficiency of the Procurement Agency and they believe that products and services will be “certainly” sold by the winner of the tendering procedure to Public Entities, many suppliers, both efficient and inefficient, will make an offer in order to award the Framework Contract.

Let assume that the Central Procurement Agency awards the contract to a supplier providing good levels of price for quality for that product/service. At the intuitive level a good percentage of public Entities will buy from this supplier.

When the contract is expired, the Central Procurement Agency will re-open the competition among suppliers, in order to award a new contract for the same good/service. Suppliers participating to the second round competition know that products/services included into the first Frame Contract have been completely sold by the first winner. Indeed,

they consider fruitful to participate again to the tendering procedure in order to afford the contract.

As a consequence, the tendering procedure will receive higher participation and higher discounts with respect to the previous edition. The most efficient suppliers will participate too, and the new contract will be awarded at a better price for quality than the previous one.

As a result, the large majority of Public Entities will certainly buy from the Framework Contract. Indeed the on-boarding activity of both sides of the market is successfully given, and the participation of Public Entities influences the good performance of the competitive tendering procedures.

Vicious Cycle

Suppliers do not expect that Public Entities will buy through the contract awarded by the Central Procurement Agency. This level of “uncertainty” is paid by the Procurement Agency through offers submitted from suppliers that do not present a good price for quality level. Consequently, since the “first class” Public Entities are free to buy or not from the winning supplier chosen by the Central Procurement Agency, they prefer to satisfy their needs by negotiating in the market. In fact, since they respect the terms of payment, they can negotiate with the efficient suppliers and achieve products/services at a advantageous price.

When the Frame Contract is expired and a new tendering procedure must be published for the awarding of the second edition of the Framework Contract, the efficient suppliers in the market will strategically decide to do not submit an offer. In fact, since Public Entities are not forced to join the Central Procurement Agency, the efficient firms will directly contact the “first class” Public Entities.

In addition, efficient suppliers strategically assume that only the “lazy” Public Entities – those Entities that do not guarantee terms of payments - will buy products/services from the Framework Contract, since they do not obtain good offers when they negotiate with efficient suppliers. In addition, the “lazy” Public Entities do not want to negotiate with the inefficient suppliers, because their prices or their quality is not enough competitive with respect to the results that the Central Procurement Agency can achieve.

As a result, the Central Procurement Agency, promoting the competition between suppliers, risks to receive offers only from the inefficient suppliers. These suppliers are then obliged, if they want to sell to Entities, to participate to the tendering procedure. The Frame Contract is then awarded at poor price for quality level.

What emerges is that, from the one hand, the efficient Public Entities continue to negotiate directly with the efficient suppliers, and, from the other hand, the Central Procurement Agency will get on board only the “lazy” Public Entities that are rejected from efficient suppliers.

For this reason, a vicious cycle begins. The side of the platform composed by of the “lazy” Public Entities influences the side of the platform populated by inefficient suppliers and vice versa. In other words, the platform gets on board “lemons” of the market.

Second Scenario - the Government obliges Public Entities to buy through the platform

In this scenario, when deciding to set up the Central Procurement Agency, the Government also announces to Public Entities that they will be forced to satisfy their needs through the goods/services available from the Frame Contracts offered by the Central Procurement Agency.

It is intuitive to figure out that, since the demand side is now captured from the Central Procurement Agency, the suppliers have certainty about the business that they will afford if they win the tendering procedure. As a result, all the suppliers, the efficient and inefficient ones, will submit an offer.

In this context the virtuous cycle previously described is automatically activated and suppliers will be more and more competitive in order to afford the contract.

In conclusion, the description of the two scenarios demonstrated that, when the Government decides to centralize public expenditure by setting up a Central Procurement Agency, he also has to oblige the Public Entities to use the Agency’s services.

MEDIUM-LONG RUN. PUBLIC ENTITIES STILL OBLIGED?

Assuming that the Government adopt to the second scenario, it is important to stress the fact that, since both kind of Public Entities (“first

class” and “lazy” ones) are forced from the Government to join the Procurement Agency services, the price offered by suppliers when submitting an offer will take into account the losses (cost of money) generated from “lazy” Public Entities. This consideration shall be taken carefully into account by the Government, since the good Public Entities obliged to join the platform “**pay**” **higher prices** that are influenced by the presence in the platform of “lazy” Public Entities. As a consequence, if the average prices offered by the winning suppliers are competitive with respect to prices achieved by the “lazy” public Entities, they are not comparable with prices otherwise afforded by the good public Entities that negotiate directly with efficient public Entities.

In order to avoid this price distortion generated by the financing model adopted by the of the Procurement Agency, in the medium-long run, when both sides of the market populate the platform, The Government shall let the public Entities free to join system by charging the inefficient ones and re-distributing to suppliers a portion of that income.

In fact, we can figure out that the “lazy” Public Entities pay a **yearly registration fee** when buying from the winning supplier of the Framework Contract. In order to guaranteeing the on-boarding of this kind of Public Entities, the registration fee shall be lower than the difference between the price offered by the winning supplier and the market price that the “lazy” Public Entities usually pay on the private market,.

Indeed, a percentage of that registration fee can be directly adopted by the Procurement Agency to finance his activities, and the remaining portion can be used to create a sort of “warranty stock” for suppliers that do business with “lazy” Public Entities.

In year 2, when a new registration fee to public Entities is requested, the Central Procurement Agency may reduce or revoke the registration fee to “lazy” public Entities that became “first-class.”

At the intuitive level, this mechanism: *stimulates* suppliers to be even more competitive when submitting an offer for the contract, since the risk generated by the “lazy” public Entities is reduced; *enhances* “lazy” public Entities to become “first class” ones; *guarantees* to good public Entities better prices; *increases* the network effects generated by the Procurement Agency.

However, the mechanism of obliging lazy public bodies to pay a tax for their inefficiency generates in the market only an increase of public debts, because the public entities do not pay on time because they do not have sources to spend.

For this reason, instead of a penalty to lazy public administrations, the Central Procurement Agency could stimulate efficiency of the system by assigning a **bonus** to those first-class public Entities that further reduce their terms of payment (let say from 90 days to 60 day and so on). This mechanisms increases the profits for the supplier that reduces the cost of cash.

CONCLUDING REMARKS

This paper provided few intuitions about the strategic decisions of obliging or not public Entities to join a new Central Procurement Agency. It demonstrated that at the start-up phase it is crucial to force the on-boarding of Public Entities, in order to guarantee to suppliers a good level of certainty about their revenues. In contrast, in the medium-long run it is more efficient to do not impose any obligation to public Entities.

These conclusions are given in a simplified model. Further developments of the paper could be treated in the future, like for example, the introduction in the model of “Framework Agreements”, as defined by the European Directive, allowing the opportunity of reopening the competition among more than one supplier selected or of renegotiating some aspects of the contract.

Moreover, in our scenarios we assumed that the final objective for a Central Procurement Agency is to achieve the efficiency of the platform. For that reason the fee applied to the “lazy” Public Entities balances the losses suffered by the “first class” Public Entities. In contrast, if the goal assigned to the Procurement Agency is to obtain savings for the Public Entities at a national/regional level, what emerges is that the statement of “first-class” Public Entities subsidizing the “lazy” Public Entity is accepted. Indeed, the introduction of these aspects in the models previously described will probably bring to a different conclusion: when pursuing the goal of global savings, Public Entities, even in the medium-long run must be obliged to buy from the Central Procurement Agency’s Framework Contracts, in order to guarantee a continuous population of

the demand side and, consequently, a sound population of the market side.

In addition, problems related to the bundle of demand and the risk of excluding Small and Medium Enterprises when Public Entities are obliged to join the Central Procurement Agency were not taken into account in this context. In fact, when SME's represent a "political" problem, under the circumstance of Public Entities obliged to buy from the Agency, it is convenient for the Government to choose a "hybrid" obligation of Public Entities, e.g by obliging them to buy only a portion of their needs through the framework contracts offered by the procurement Agency.

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NOTES

1. See also Dimitri, Dini and Piga (2006).
2. See Carpineti, Piga and Zanza (2006).
3. The Italian Law 296 21 December 2006 states that "In order to contain the public debt and to rationalize the public expenditure for the procurement of goods and services, each Region can set up a Central Procurement Agency, even jointly with other regions...in favour of Entities and public entities, local authorities and health authorities and of other public Entities operating in the region."
4. Some examples of centralized public procurement agency at local level in Italy are: Centrale Regionale Acquisti (Lombardia) SORESA (Campania), Empulia (Puglia), CAT (Sardegna), Intercent (Emilia Romagna).
5. See Jullien (2004).

6. See Jullien (2004).
7. In this paper, Framework Agreements, as defined by the Article 32 of the Directive 2004/18/EC, are not taken into account. In this context, the Procurement Agency awards the contract only to one supplier and there is not a re-negotiation between the winner of the competition and the public Entities.
8. See Rochet and Tirole (2004).

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