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Feature Comment: Considering The Effects of Public Procurement Regulations on Competitive Markets

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FEATURE COMMENT: Considering The Effects Of Public Procurement Regulations On Competitive Markets

Professor Albert Sanchez Graells of the University of Hull (UK) recently published a vitally important book on procurement law, *Public Procurement and the EU Competition Rules* (Hart Publishing 2011). In his carefully researched study, Sanchez Graells asked what seems like a simple question: Shouldn't regulators, when writing procurement regulations, consider the likely impact of those regulations on competitive markets? Sanchez Graells, who will be addressing this point at an upcoming George Washington University Law School symposium, pointed out that far too little attention has been paid to the anticompetitive impact of public procurement regulation:

[T]his significant area of overlap between competition and public procurement law (ie, the competition distortions that public procurement regulations and administrative practices can produce themselves) still remains unexplored. Generally, publicly-created distortions of competition in the field of public procurement have not yet been effectively tackled by either competition or public procurement law—probably because of the major political and governance implications embedded in or surrounding public procurement activities, which make development and enforcement of competition law and policy in this area an even more complicated issue, and sometimes muddy the analysis and normative recommendations. Notwithstanding these relevant difficulties, ... this is a very relevant area of competition

policy to which development could bring substantial improvements and, consequently, it merits more attention than it has traditionally received.

Id. at 9.

This FEATURE COMMENT assesses Sanchez Graells' thesis from a U.S. perspective. As the discussion below explains, in many ways the U.S. federal procurement system stands at one end of a spectrum. Even when the question was squarely before regulators—when they were assessing how procurement rules should be shaped to take advantage of commercial efficiencies—regulators apparently never seriously considered the collateral impact of their rules on those same markets.

Regulators in the U.S. federal system instead typically focus on *best value*, i.e., on how to shape procurement rules to maximize competition *within* a procurement itself, to gain the best value for the public money spent. See, e.g., FAR 1.102(a), 48 CFR § 1.102(a) (“The vision for the Federal Acquisition System is to deliver on a timely basis the best value product or service to the customer, while maintaining the public's trust and fulfilling public policy objectives.”). As the discussion below explains, although there is clear legal authority calling for a prospective analysis of procurement rules' costs and benefits to the competitive marketplace, U.S. policymakers often fail to assess the competitive impact that procurement regulations are likely to have.

At the other end of the spectrum, European regulators often place *first* emphasis on procurement regulations' impact on the market—sometimes to the detriment of best value. As the University of Nottingham's Professor Sue Arrowsmith recently argued, while the EU's procurement directives set minimum requirements for all the European member states' procurement laws, European policymakers' central goal in framing those directives was to integrate the European internal market—not to maximize best value in procurement.

[T]he directives are concerned primarily to promote the internal market, as indicated by

their legal base, and ... they do this by performing three functions: prohibiting discrimination, securing transparency to allow monitoring and enforcement of the non-discrimination rule, and removing barriers to market access.

* * *

Finally, and importantly, we rejected the notion that the directives seek value for money [best value] for Member States, either in a narrow sense of reliably securing what is needed on the best terms, or in a wider sense that embraces the decision on what to buy.

Arrowsmith, “The Purpose of the EU Procurement Directives: Ends, Means and the Implications for National Regulatory Space for Commercial and Horizontal Procurement Policies,” at 46–47, in *The Cambridge Yearbook of European Legal Studies 2011–2012*, Vol. 14 (Barnard, Gehring and Solanke, eds., Hart Publishing 2013).

The discussion below, following Sanchez Graells’ lead, suggests a middle course. Rather than making economic integration the focus of procurement regulation (the approach that Arrowsmith attributes to the EU procurement directives), the discussion below suggests that those drafting federal procurement rules in the U.S. should consider the impact of those rules on the broader competitive market, and should mold those rules, if appropriate, to minimize adverse competitive impacts. This would *not* mean that the procurement rules exist primarily to integrate the broader commercial market (the European focus), but rather would mean that the U.S. procurement system governed by those rules would, to the extent possible, integrate efficiently with that commercial market.

Why Regulators Should Assess Procurement Rules’ Impacts on the Broader Market—There is a substantial body of literature, both nationally and internationally, which confirms that procurement rules can have significant anticompetitive effects, both inside and outside the procurement market. See, e.g., Anderson, Kovacic and Müller, “Ensuring Integrity and Competition in Public Procurement Markets: A Dual Challenge for Good Governance,” in *The WTO Regime on Government Procurement: Challenge and Reform* 681 (Arrowsmith and Anderson, eds., World Trade Organization 2011); Anderson and Müller, “Competition Policy and Poverty Reduction: A Holistic Approach,” at 12 (WTO Staff Working Paper ERSD-2013-02, Feb. 20, 2013), available at ssrn.com/abstract=2223977; Yukins, “A Case Study in Comparative Procurement

Law: Assessing UNCITRAL’s Lessons for U.S. Procurement,” 35 Pub. Cont. L.J. 457, 462–63 (2006) (assessing anticompetitive impact of electronic procurement regulations); Nensala, “Homeland Security Presidential Directive 12: How HSPD-12 May Limit Competition Unnecessarily and Suggestions for Reform,” 40 Pub. Cont. L.J. 619 (2010) (impact of security regulation on competition); Haberbush, “Limiting the Government’s Exposure to Bid Rigging Schemes: A Critical Look at the Sealed Bidding Regime,” 30 Pub. Cont. L.J. 97, 103 (2000) (sealed bidding, as required by Government, itself facilitates bidder collusion); Malhotra, “Study on Government Procurement: Study for Evidence-Based Competition Advocacy” (January 2012) (case studies of how Indian procurement rules have anticompetitive impact), available at sps.iitd.ac.in/PDF/SGP.pdf; UK Office of Fair Trading, “Assessing the Impact of Public Sector Procurement on Competition” (2004) (privately prepared report), available at www.oft.gov.uk/shared_oftr/reports/comp_policy/oft742b.pdf. But cf. Thaggert, “Antitrust and Public Procurement—The United States,” 7 Comp. L. Int’l 82, 84 (2011) (describing U.S. federal procurement disclosure rules which are intended to stem anticompetitive conduct by bidders).

As studies have emphasized, procurement rules can have—or mask—significant anticompetitive behavior. See, e.g., Cushman, “The ABA Model Procurement Code: Implementation, Evolution, and Crisis of Survival,” 25 Pub. Cont. L.J. 173, 193–94 (1996) (“procedural compliance with [procurement] rules can actually mask improper conduct rather than prevent[] it; compliance with form disguises anticompetitive or worse activities”). These anticompetitive impacts may include the following.

Raising Barriers to Entry: Rigid rules governing competition in procurement can, in effect, lock prospective bidders out of a procurement market. See, e.g., Kennedy-Loest, Thomas and Farley, “EU Public Procurement and Competition Law: The Yin and Yang of the Legal World?,” 7 Comp. L. Int’l 77, 80 (2011) (closely limited awards in Northern Ireland of indefinite-delivery, indefinite-quantity (framework) agreements locked out potential competitors). These barriers can, in turn, cripple those firms that otherwise would have competed in related commercial markets, if they had used public contracts to leverage their market positions.

Collusion among Bidders: Because of the nature of the Government’s highly structured bidding process, that process may, in practice, facilitate collusion

among bidders. See, e.g., Haberbusch, *supra*, at 103; Albano and Spagnolo, “Asymmetry and Collusion in Sequential Procurement: A ‘Large Lot Last’ Policy,” 10 B.E. J. Theoretical Econs., Art. 43 (2010); Ishii, “Favor Exchange in Collusion: Empirical Study of Repeated Procurement Auctions in Japan,” 27 Int’l J. Indus. Org. 137 (2009). Some observers believe that this can, in turn, have spillover effects in the private marketplace, as public bidders leverage collusion in public markets for gains in commercial markets. Cf. DeSanti and Nagata, “Competitor Communications: Facilitating Practices or Invitations to Collude? An Application of Theories of Proposed Horizontal Agreements Submitted for Antitrust Review,” 63 Antitrust L.J. 93 (U.S. Federal Trade Commission alleged that manufacturers used public procurement auctions for competitor communications).

Artificially Buoying Price: Government pricing policies in procurement also may have a collateral effect in the commercial market. The General Services Administration, for example, insists that contractors on its Multiple Award Schedule (MAS) contracts commit to pass any commercial discounts on to the contractors’ Government customers as well. The MAS most-favored customer provision, known as the Price Reductions clause, means, in practice, that vendors, competing in a market where all competitors face collateral price impacts for lowering their commercial prices, may decline to decrease their prices, public or commercial. See, e.g., Woodward, “The Perverse Effect of the Multiple Award Schedules’ Price Reductions Clause,” 41 Pub. Cont. L.J. 527, 544–49 (2012). A price effect of this type is in keeping with the economic literature, which warns that most-favored customer provisions can artificially buoy prices in the commercial marketplace by discouraging price discounting. See, e.g., Cooper, “Most-Favored-Customer Pricing and Tacit Collusion,” 17 Rand J. Econs. 377 (1986).

There is, therefore, little doubt that procurement rules can have significant competitive impacts in the commercial marketplace—and, indeed, there is substantial agreement on the *types* of impacts those rules may have. The question, then, is whether U.S. regulators have considered those potential effects when framing new procurement rules.

The Commercial-Item Revolution: A Lost Opportunity to Consider Market Impact—One obvious opportunity for regulators to have considered the market impact of procurement rules was when the Government changed its rules to facilitate

commercial buying by the Government. Regulators were reshaping the procurement rules to bring federal purchasers of commercial items into the private marketplace; it would have been a logical extension of those reforms to consider those revised rules’ impact on that private marketplace. To this day, it remains a puzzle why U.S. regulators apparently never considered the market impacts of the new commercial-item purchasing rules.

In the 1990s, the U.S. Government substantially reshaped its procurement rules regarding the purchase of commercial goods and services—“commercial items,” as they are known in the Federal Acquisition Regulation. FAR 2.101 and pt. 12, 48 CFR § 2.101 and pt. 12. See generally O’Sullivan and Perry, “Commercial Item Acquisitions,” 97-05 Briefing Papers 1 (April 1997).

In retrospect, one striking aspect of the commercial-item revolution was that in developing the new rules, the Government never undertook—nor apparently even considered—a formal analysis to determine the new rules’ market impact. That economic-impact analysis probably would have been part of a cost-benefit assessment, and cost-benefit analysis was already an established aspect of U.S. rulemaking. See EO 12291, 46 Fed. Reg. 13193 (Feb. 19, 1981), available at www.archives.gov/federal-register/codification/executive-order/12291.html; see also EO 12866, 58 Fed. Reg. 51735 (Oct. 4, 1993), available at www.whitehouse.gov/omb/inforeg/EO12866.pdf. See generally title II of the Unfunded Mandates Reform Act of 1995 (2 USCA §§ 1532–1538) (calling for an assessment of economic impact).

Moreover, a number of published studies had already warned that public procurement rules could cause significant distortions in commercial markets. See, e.g., Sanchez Graells, *supra*, at 11, 56–57 (citing Kettl, “Sharing Power: Public Governance and Private Markets,” at 31 (1993); ABA Section of Antitrust Law, *Antitrust Law Developments*, at 1107–09 (3d ed. 1992); Note, “Gains from a Unified European Community Public Procurement Market: An Analysis Using Auction Theory,” 1990 Brigham Young University Law Review 1727, 1729 (1990); Carroll and Scott, “The Modification of Industry Performance through the Use of Government Monopsony Power,” 3 Indus. Org. Rev. 28 (1975); Round, “The Impact of Government Purchases on Market Performance in Australia,” 1 Rev. Indus. Org. 94 (1984)). Finally, the federal public procurement system was already an economic behav-

moth by the time of the commercial-item reforms—by fiscal year 1988, federal procurement had reached \$200 billion annually. See Office of Federal Procurement Policy, “Federal Procurement Data System: Standard Report, Fiscal Year 1988 through Fourth Quarter (October 1, 1987 through September 30, 1988),” at 2, available at www.fpds.gov/downloads/FPR_Reports/Fiscal%20Year%201981%20-%202002/FEDPROCREPORT_FY1988-4Q.pdf.

As a result, an objective observer likely would have concluded that the commercial-item reforms would have a material impact on the broader competitive economy because the reforms would allow the Government to play a much larger role, as a buyer, in the commercial markets. These new public procurement regulations, specifically intended to increase the Government’s presence in the broader commercial market, with attendant costs and benefits, were therefore precisely the type of rulemaking that should have triggered an analysis of the rules’ likely impact on the competitive markets. Cf. Shapiro and Brainard, “Trade Promotion Authority Formerly Known as Fast Track: Building Common Ground on Trade Demands More Than a Name Change,” 35 *Geo. Wash. Int’l L. Rev.* 1, 30 and n. 166 (2003) (proposed U.S. legislation, intended to reduce market barriers to entry, would have required that international trade agreements regarding procurement call for cost-benefit analyses of proposed procurement rules).

The administrative record, however, indicates that the drafters of the new policies never considered such a cost-benefit analysis. Cf. 60 *Fed. Reg.* 48231 (Sept. 18, 1995) (although commercial-item rulemaking was, by its terms, subject to Office of Management and Budget review under EO 12866, notice accompanying sweeping new FAR pt. 12 (commercial-item) rules made no reference to cost-benefit analysis or to the impact of new commercial-item rules on competitive markets); see also Office of Information and Regulatory Affairs, OIRA historical reports search webpage, available at www.reginfo.gov/public/do/eoHistReviewSearch, under “Agency” pull-down menu select “Department of Defense,” and under “Calendar Year” select “1995” (RIN 0750-AB00, the OIRA report number for the DOD changes to commercial-item acquisition based on FASA, indicates that DOD classified the revolutionary commercial-items regulatory changes as “not economically significant”; a cost-benefit analysis is only required for economically significant regulatory changes, see *infra* pg. 7). The

two key (and comprehensive) reports that established the foundation for the commercial-item reforms were the 1986 “Packard Commission” report and the 1993 “Section 800 Panel” report. See “Report of the Acquisition Advisory Panel to the Office of Federal Procurement Policy and the United States Congress” 39–41 (January 2007) (discussing history). In both of those reports, however, the reformers’ central goal was to lower prices for public procurements; the answer, in both instances, was to rely more heavily on the commercial market.

One of the primary findings of the Packard Commission, for example, was that then-current public procurement regulations allowed agencies to require Government-unique specifications for Government products, “*despite the commercial availability of adequate alternative items costing much less*” (emphasis added). See President’s Blue Ribbon Commission on Defense Management, “A Quest For Excellence: Final Report to the President,” at 44, 60 (June 1986), available at www.ndu.edu/library/pbr/36ex2.pdf. The Packard Commission therefore recommended that “[r]ather than relying on excessively rigid military specifications, [the Department of Defense] should make much greater use of components, systems, and services available [commercially] ‘off the shelf.’ ” *Id.* at xxv.

Similarly, the Section 800 Panel identified DOD’s primary acquisition threat as a “continued reliance by DOD on defense-unique products [that] can only mean *higher costs and loss of industrial base for DoD*” (emphasis added). See DOD Acquisition Law Advisory Panel, “Streamlining Defense Acquisition Laws: Executive Summary,” at 12 (March 1993), available at www.dtic.mil/cgi-bin/GetTRDoc?AD=ADA264919. The perspective thus was one-sided: reformers considered only what the commercial market could do for the Government’s public procurement, and the reports never seemed to consider what the revamped public procurement regulations would do to the competitive commercial markets.

Rulemaking Should Consider Costs and Benefits, Including Market Impacts—Twenty years later, the commercial-item revolution appears to be receding in the face of new statutes and regulations that have reversed many of its initial gains. See, e.g., Acquisition Reform Working Group, “2012 Legislative Recommendations,” at 12 (April 2012), available at www.ndia.org/advocacy/resources/pages/arWG.aspx. Should the regulatory pendulum

swing towards liberalized commercial-item procurement again, however, regulators should first consider the impact of those revised rules on the commercial markets.

The analysis of empirical data of that kind will allow public procurement policymakers to weigh the prospective economic costs of different approaches, which will in turn help guide public procurement rulemaking that has net positive impacts on the economy. The specific processes used to incorporate cost-benefit analysis will depend on the particular regulation being considered. Here, we consider how, within the analytical framework contemplated by law, the Government would incorporate cost-benefit analyses into its public procurement rulemaking processes.

The primary procedural requirements for U.S. rulemaking are established by the Administrative Procedures Act. See 5 USCA §§ 551–559. The APA establishes requirements for five types of rulemaking processes: formal, informal, hybrid, direct final and negotiated rulemaking. *Id.* §§ 552–557; see also Burrows and Garvey, Congressional Research Service, “A Brief Overview of Rulemaking and Judicial Review,” CRS Report No. R41546, at 1 (Jan. 4, 2011). The informal notice-and-comment rulemaking contemplated by the APA is the most common form of rulemaking in executive agencies, and is the type of rulemaking normally used for public procurement rules under the FAR. See Manuel et al., CRS, “The Federal Acquisition Regulation (FAR): Answers to Frequently Asked Questions,” CRS Rep. No. R42826, at 11 (Nov. 16, 2012).

It has been noted, however, that rulemaking under the FAR is not, strictly speaking, governed by the APA. See *U.S. v. AEY, Inc.*, 603 F. Supp. 1363 (S.D. Fla. 2009). The APA, by its terms, exempts Government procurement contracts from its notice-and-comment requirements. See 5 USCA § 553(a). Instead, rulemaking under the FAR is governed by the Office of Federal Procurement Policy Act, 41 USCA § 1301 et seq., and the FAR includes its own notice-and-comment provision at FAR 1.501, 48 CFR § 1.501. See *AEY*, 603 F. Supp. at 1374.

In federal rulemaking, the most extensive requirements for cost-benefit analysis—which would, presumably, be the rubric under which procurement regulations’ market impact would be assessed—have come through executive orders and guidance. See, e.g., Copeland, CRS, “Cost-Benefit and Other Analysis Re-

quirements in the Rulemaking Process,” CRS Report No. R41974, at 3, 11 (Aug. 11, 2011), available at www.fas.org/sgp/crs/misc/R41974.pdf.

EO 12866, issued by President Clinton on Sept. 30, 1993, remains in effect for executive agency cost-benefit analysis requirements. 58 Fed. Reg. 51735 (1993). President Obama reaffirmed “the principles, structures, and definitions governing contemporary regulatory review that were established in Executive Order 12866 of September 30, 1993.” See EO 13563, 76 Fed. Reg. 3821 (Jan. 21, 2011), available at www.whitehouse.gov/sites/default/files/omb/inforeg/eo12866/eo13563_01182011.pdf. EO 12866 applies to cabinet-level agencies and independent agencies, but not to independent regulatory agencies. *Id.* § 3(b). Notably, § 3(d) of the order, which defines the “regulations” or “rules” covered by the order, *exempts* regulations that pertain to military functions, “*other than* procurement regulations” (emphasis added). This “double-negative”—an exception to an exemption—thus seems to bring the FAR’s procurement regulations squarely within EO 12866 and its requirement for a regulatory cost-benefit analysis.

Section 3(f) of the executive order defines economically significant rules as agency regulations that may “[h]ave an annual effect on the economy of \$100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities” (emphasis added). *Id.* § 3(f)(1). Section 6(a)(3)(C) of the executive order then requires agencies proposing economically significant rules to incorporate into their decision-making process a cost-benefit analysis of the proposed rule, and an assessment of reasonable alternatives to the proposed rule.

In September 2003, OMB issued Circular A-4, which standardized “the way benefits and costs of Federal regulatory actions are measured and reported.” See OMB, “Circular A-4—Subject: Regulatory Analysis,” at 1 (Sept. 17, 2003), available at www.whitehouse.gov/sites/default/files/omb/assets/regulatory_matters_pdf/a-4.pdf; see also OIRA, “Regulatory Impact Analysis: A Primer,” at 2–3, available at www.whitehouse.gov/sites/default/files/omb/inforeg/regpol/circular-a-4_regulatory-impact-analysis-a-primer.pdf. It also requires an agency to provide its proposed rule’s cost-benefit analysis, called a regulatory impact analysis,

to OIRA for review. See OMB, “Circular A-4—Subject: Regulatory Analysis,” at 48.

The impacts that economically significant procurement rules have on competitive commercial markets are, it seems, precisely the types of impacts contemplated by EO 12866 and OMB Circular A-4—the impacts which should be assessed during the rulemaking process, as part of a broader cost-benefit analysis. The “commercial market” is part of the “economy,” and certainly a “sector of the economy” under the executive order, and many proposed public procurement rules will easily reach the \$100 million threshold, since the size of the annual federal public procurement market currently exceeds \$500 billion.

A proposed rule governing commercial items, which touched only 1/50th of one percent of the \$500 billion federal procurement budget, for example, would still reach the \$100 million threshold for economically significant rules, subject to the executive order. And even if that monetary threshold is not met, the executive order arguably reaches, in the alternative, procurement rules which will materially affect competition in the economy—which is precisely the adverse economic impact warned of by so many economic studies, such as those previously cited.

Were the U.S. to adopt this approach, and weigh in advance the adverse competitive effects of procurement rules, the Government could avoid rules with substantial net negative impacts on the economy. The Government would, moreover, be acting in accord with international best practices. Although every country has slightly different rulemaking processes, cost-benefit analysis is being embraced internationally where, as here, a rule is likely to have a material competitive impact. See, e.g., Organisation for Economic Cooperation and Development, “Recommendation of the Council on Regulatory Policy and Governance” (March 12, 2012) (calling for prospective assessment of competitive impacts).

Conclusion—As the discussion above reflects, a substantial body of literature confirms that procurement rules can have a significant negative impact on competitive commercial markets. Procurement rules can, for example, raise new barriers to entry in the commercial marketplace, facilitate collusion in the commercial space, or artificially buoy commercial prices. Federal procurement regulators have not, as a regular matter, assessed those possible impacts in past rulemaking, but sound practice and legal authority, including an executive order, seem to call for such assessments. Assessing procurement rules’ likely impact on competitive markets would be in accord with best practices in rulemaking, and would help ensure that the federal procurement system integrates efficiently, and not disruptively, into the broader economy.



This Feature Comment was written for The Government Contractor by Christopher R. Yukins and Lieutenant Colonel Jose A. Cora. Chris Yukins is a Professor of Government Contract Law and Co-Director of the Government Procurement Law Program at the George Washington University Law School. Jose Cora is a Judge Advocate in the U.S. Army, was an Associate Professor of Contract and Fiscal Law at the U.S. Army JAG School from 2007–2010, and is currently a 2013 George Washington University LL.M. Candidate in Government Procurement Law. Further information on the GWU Law School March 12 and 14, 2013 symposium on competition and procurement law is available at www.law.gwu.edu/News/2012-2013Events/Pages/CompetitionProcurementSymposium.aspx. Several of the authors cited in this article, including Albert Sanchez Graells, Gian Luigi Albano, William Kovacic and Robert Anderson, will be speaking at that symposium on March 14.