Bidding farewell? The ‘bidding market’ defence in competition investigations

A common defence in competition cases (particularly those involving mergers) is that the market is a ‘bidding market’ and, as such, two or three competitors are sufficient for the market to be contestable. The extensive auction theory literature is not always readily applicable to the assessment of competition issues, so what practical ways are there of looking at bidding markets in order to analyse such issues?

In recent years, parties in a number of competition cases have argued that a given market is a ‘bidding market’, which therefore presents fewer competitive concerns (for example, as a result of a merger). The justification for such a defence is that, in a bidding (or auction) market, large market shares do not imply market power, and two or three competitors are enough to keep prices in check, because competition is for the market rather than in the market.

A bidding market—that for jet engines—was central to the much-debated General Electric (GE)/Honeywell case. This example brings to light the difficulty of assessing market power in a bidding market: if a firm wins an auction for a large contract, it may become a near-monopolist for the duration of that contract. However, if the market is contestable, the firm does not necessarily have market power. As evidence of GE’s alleged market power, the European Commission had argued that: ‘on 10 out of the last 12 platforms for which airframe manufacturers offered exclusive positions, GE managed to place its products.’ The Commission also argued that current market shares are a good proxy for present and future market power, because winning contracts allows firms to invest in R&D, and because incumbency can play a role in buyers’ future purchasing decisions. However, the US Department of Justice, which also reviewed the merger, argued that static market shares are ‘a weak indicator of competitive conditions in the market’, and that GE’s high market share was largely due to one particularly large contract that had recently been won.

This example illustrates the sort of arguments that are likely to come into play in a competition case where bidding markets are invoked. This article explores possible systematic ways of looking at competition issues in bidding markets in practice. There is a considerable body of auction theory literature, with models that test the effects of varying assumptions regarding, for example, information asymmetries (private versus common values), risk-aversion, capacity, allocative externalities, and multi-unit auctions. However, in reality, it can be difficult to determine which model to apply to a given market; moreover, the models often do not take into account dynamic market interactions (such as entry or collusion) that are particularly important for competition policy. This article therefore illustrates a few simple examples of market characteristics or outcomes that are relevant to bidding markets.

Four simple criteria?

The Competition Commission recently published a paper by Paul Klemperer exploring the theoretical aspects of bidding markets and how they can inform the analysis of competition issues. The paper challenges the argument that standard competition assessments do not hold in bidding markets. Klemperer argues that there are many cases where the competitive assessment of bidding markets should be no different from that of ordinary markets—indeed, in some cases, a bidding market may give rise to more competitive concerns than an ordinary market.

According to Klemperer, an ‘ideal’ bidding market meets four criteria (p. 6):

1) competition is winner-take-all—the bidder wins all or none of the contract;
2) competition is lumpy—each contract is large relative to a bidder’s total sales;
3) competition begins afresh for each auction—there is no ‘lock-in’ such that the incumbent supplier is advantaged;
4) entry is easy.
When the four criteria are met (that is, one firm is enough) the market is contestable. If at one point in time the firm that has won the contract has a 100% market share, the price outcome will be perfectly competitive, even if there are only two competitors, as in the standard oligopoly model of Bertrand competition. Klemperer also notes that the presence of a fifth characteristic—a ‘bidding system’ or ‘bidding process’ used to clear the market—is neither necessary nor sufficient for an ‘ideal’ bidding market to exist.

It is easy to see, however, that the above criteria are not clear-cut, but that each represents one dimension of the market over which there is a grading scale: from markets with no bidding aspects at one extreme, to those that are ‘pure’ bidding markets at the other. For example, in a pool market for electricity, contracts are small since firms auction individual units—therefore, more than one firm wins a contract. This clearly does not satisfy the ‘winner-take-all’ criterion. In such a market, it is clear that the number of bidders influences the final price. Indeed, there is much empirical evidence of the market price being influenced by the number of bidders, suggesting that many bidding markets do not satisfy all of the above conditions.

A schematic representation of bidding markets versus ordinary markets can be achieved if the above four criteria are simplified into two dimensions. The first encompasses criteria 1 and 2, and can be summarised as ‘size of contract’. This involves various aspects of the bidding process, such as its frequency (given the fact that if auctions are frequent, the relative importance of each contract decreases); the size of the contract relative to that of the overall market and of market players; and the number of contracts awarded within each auction. The second dimension encompasses criteria 3 and 4, and can be described as ‘ease of entry’. This dimension covers not only the objective entry barriers to a market (eg, sunk costs), but also the incumbency effects of the existing supplier (eg, reputation).

Several other studies have also explored market features and outcomes that should be considered in assessing the competitiveness of a bidding market. In an analysis of the GE/Honeywell merger, Patterson and Shapiro (2001) argue that, in order to evaluate competition in bidding markets, a series of questions have to be asked. In contrast to Klemperer’s criteria, these look more at the bidders and the nature of their interactions, rather than at the market structure.

1) Do multiple suppliers typically enter the bidding competition?
2) Do customers consider these suppliers capable of offering good alternatives?
3) Have suppliers historically preserved their strengths and capabilities despite setbacks?
4) Is bidding vigorous? Are there multiple rounds of bidding in which the bids move significantly? Do suppliers offer major concessions to win the bidding?
5) Have multiple suppliers shown the ability actually to win bids with regularity?
6) Are multiple suppliers positioned technically to remain capable and attractive for upcoming bidding events?

Again, answering these questions is not always straightforward, and what matters is the degree to which each proves to be the case. The following examples look at the practical ways in which some of these questions can be answered and how a given market might be placed in Figure 1.

**Implications for market definition**

The first problem with assessing competition issues in a bidding market is that of defining the relevant market. The SSNIP test (small but significant non-transitory increase in price) is unlikely to be effective in many cases (at least in its traditional application), since the price level will not be clear and may vary across contracts and consumers. This will be the case particularly when the market is not one in which the product is homogeneous (agricultural produce, oil, electricity) but is bespoke (construction projects), since there will not be any comparators. As Klemperer explains, if competition is ‘winner-take-all’, there is no ‘smooth trade-off between the price offered and the quantity sold’ (p. 6).
If contracts are very different, another implication could be that each auction is a separate market from a demand-side perspective. However, it may be more important to look at supply-side substitution, where what matters is who is able to bid for a particular contract.

Some assessments are easier to make in bidding markets: if two firms bid against each other, it could be argued that they are operating in the same market. For example, for the purposes of a merger, this evidence can be used to determine whether firms are horizontal competitors (and therefore operating in the same market).

This issue was discussed by the UK Office of Fair Trading (OFT) in the 2005 Celesio/HSG merger, where it was noted that:

The [merging] parties argue that their businesses are largely complementary in the healthcare logistics sector … Bidding data supplied by the parties do, however, suggest that Farillon [a subsidiary of Celesio] and HSG have bid against each other, and third parties confirm that the firms have been in direct competition. It therefore appears that the parties were competitors pre-merger.7

Data on the frequency with which certain companies bid against each other can therefore be used to determine the extent to which they compete in a given market.

How many competitors are enough?

As mentioned above, if a bidding market is ‘impure’, the number of bidders will have an effect on the competitiveness of the market. Among the Patterson and Shapiro questions outlined above, 1 and 2 relate to the number of competitors and therefore the competitive constraint on a firm. However, adding further bidders does not contribute significantly to competition if these extra bidders are weak. For example, in the Cowie/British Bus Group 1997 merger, although the number of bidders decreased after the merger, there was evidence that many bids in the earlier period were not competitive since they were from very small operators.8

This is more of an issue in a bidding market than in an ordinary market, particularly if the contract is very large, because small bidders may not supply or produce anything until they win a tender: prior to the auction, their competitive constraint may be less credible. As a result, it is necessary to look not only at the auction market structure, but also its outcomes. Of course, it is also the case in a non-bidding market that not all market players will pose a competitive constraint.

Incumbency effects

Patterson and Shapiro’s question 5 asks whether more than one firm is able to win contracts regularly. If the answer to this is no, there may be incumbency effects in the market. As well as question 5, questions 3 and 6 are also relevant to Klemperer’s third criterion—that a ‘pure’ bidding market should have no ‘lock-in’ effects such that competition should start afresh for each contract. Unfortunately for the ‘bidding market defence’, if Klemperer’s first and second criteria hold—that contracts are large and winner-take-all—incumbency effects may also be more likely. With positive costs of bidding, once a firm gains a clear advantage in a market, other firms may stop trying to bid against it as the probability of winning falls (see Klemperer, p. 15, with reference to ascending auctions). This may be important in merger cases. Furthermore, there may be economies-of-scale effects that make entry more difficult. These are also likely to be particularly important in bidding markets, since a substantial investment may be required for a lumpy, winner-take-all contract to be fulfilled.

In the GE/Honeywell case, the European Commission argued that GE has incumbency advantages in the markets in which it operates, such that winning a contract would make it more likely for it to win subsequent contracts. This argument clearly depends on the sector in question: if winning a contract gives a firm market know-how, or if the firm needs to undertake substantial investment, lock-in is more likely. This was the case in the second contest to operate the National Lottery in the UK, in which Camelot, the incumbent operator, ‘had developed substantial learning-by-doing and reputation advantages by the time of the subsequent contest’, such that it faced much less competition. Moreover its sunk costs were so large that it was prepared to allocate substantial resources to ensuring that it would be awarded the next licence (Klemperer, pp. 10–11). Incumbency effects are also greater if there are reputational issues in the market. If such issues are present because the good in question has some qualitative or differentiated features, the bidding market is even less likely to be ‘pure’ or contestable: in a perfectly contestable market, the product must be homogeneous and the competitors identical.

Other issues

Markets are more likely to be contestable if firms are identical. However, such a market may also favour collusion. Along the ‘size of contract’ dimension in Figure 1, there is a sliding scale of contracts: at one extreme are very large, infrequent tenders for the whole market; at the other are very small, frequent tenders for single units. In the middle of this sliding scale—and especially if entry is not easy—there is a greater risk of collusion than in ordinary markets. The bidding process makes the market more transparent and gives firms the opportunity to communicate; the more frequent the auctions, the more credible punishment strategies become, which again favours collusion. So the questions...
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asked by Patterson and Shapiro, 'Is bidding vigorous? Are there multiple rounds of bidding in which the bids move significantly? Do suppliers offer major concessions to win the bidding?,' are useful; however, multiple rounds of bidding could also facilitate collusion.

Another common feature of bidding markets is that of buyer power. The larger the contract relative to the individual bidders, the more likely it is that the bid-taker or buyer has greater resources than the bidders themselves. This makes it more likely for the buyer to be well informed (or willing to spend resources to gain information). Buyer power is therefore often an important argument in competition cases involving bidding markets; it was a source of disagreement between the European Commission and the Department of Justice in the GE/Honeywell case, and was a determining factor in the CHC/Helicopter merger. In the latter case, buyer power was a determining factor in the UK Competition Commission's clearance of the merger between two providers of helicopter services to oil and gas offshore installations. It was considered that 'Oil companies are much larger and commercially stronger organizations than helicopter operators and their purchasing power is concentrated.' Buyer power is influenced by several factors, many of which are similar in bidding markets and ordinary markets. However, an additional source of buyer power in a bidding market is the ability to influence the auction mechanism itself. Deciding whether an auction is an ascending or sealed-bid auction, the increments in the price, the unit being auctioned, and the ability to incentivise entry, may allow the buyer to prevent some of the competition issues presented above. Being able to change the auction rules will also disrupt collusive equilibria.

**Conclusion**

Claiming that a market is a bidding market is not always a justification for arguing that a merger will not have anticompetitive effects: competitive issues must be analysed, often in the same way as in an ordinary market, and sometimes with even greater scrutiny. 'Pure' bidding markets may not be particularly common; however, many markets have some bidding characteristics, and these will be relevant for competition assessments.

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1 Court of Justice of the European Communities, Court of First Instance (2005), 'Judgment of the Court of First Instance: General Electric v Commission, Case T-210/01', December 14th.
7 OFT (2005), 'Anticipated Acquisition by Celesio AG of Healthcare Services Group plc', April 11th.
10 Ibid, Summary, p. 4.