CHARACTERISTICS OF A PROJECT AS A TEMPORARY MICRO-MARKET

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Purpose

- This paper argues a market is created by the main contractor as they go through the subcontracting process, and introduces the idea that procurement of subcontractors for a project creates an identifiable, though temporary, market for goods and services.
- The extent of market power held, gained or lost by participants as the procurement process goes through the stages of pre-bid, tender, final bid and negotiation, or some variation of those stages, is an important factor

A Project Market?

- A market is “any arrangement in which the interaction of buyers and sellers determines the price and quantity of goods and services exchanged”.

- A client is the buyer of a bundle of goods and services from the contractor/s bidding or negotiating for the project, and their interaction on the scope (quantity) and price of the project is resolved when the agreement or contract is exchanged. This could be called a micro-market.

Characteristics

- The characteristics of markets are the number of buyers and sellers, the distinctiveness and substitutability of products, forms of competition, barriers to entry and concentration ratio, and the information and mobility of customers.

- These market characteristics do not, however, carry over to industries with extensive subcontracting, such as building and construction, for three reasons.

Bargaining Power

- There is only one buyer, and in such a market with a single buyer it is possible to gain market power through bargaining with potential suppliers.

- The economic treatment of bargaining power uses the concept of outside options available to buyers and sellers, or the the best option that either the seller or buyer can achieve if they walk away from the negotiations. These walk-away options are the minimum negotiated outcome that the respective parties will accept.

Relational Exchange

- Subcontractors are typically not engaged in a single transaction, as in pure market-based trades of instant exchange and settlement.
- The relationship between a large corporation and its subcontractors is typically more durable and intensive than a market relationship.
- Instead of using the market, the firm will rely on a trusted supplier, especially when their relationship involves shared knowledge and learning

Hybrids

- There are ‘hybrid’ concepts such as the ‘quasifirm’
- As developed by Eccles (1981: 339-40) for the construction industry where “relations between the general contractor and his subcontractors are stable and continuous over fairly long periods of time and only infrequently established through competitive bidding. This type of ‘quasi-integration’ results in what I call the ‘quasifirm’.”
- It can be argued this concept of the quasifirm largely makes the concept of relational exchange redundant.

Temporary Markets

- A different approach to long-term or continuous relationships is taken here, by arguing for the idea that a project creates an identifiable, though small and temporary, micro-market for the goods and services supplied by subcontractors.
- While there may be relational aspects to the organization of production/projects between firms, the legal distinction between firms, markets and other arrangements remains real, and the legal status of the firm has not been undermined.
- Conceptual boundaries are not contractual boundaries, and this distinction should not be ignored.

Monopsony Power

- A market with single buyer is known as a monopsony (the opposite of a monopoly with a single seller).
- The treatment of buyer power in economics is concerned with how downstream firms can affect the terms of trade with upstream suppliers.
- A buyer has monopsony power if they can reduce the price paid below competitive levels by withholding demand.

Implications

- Two questions that emerge from the range of factors discussed are:

1. How might a head contractor exercise their market power when dealing with subcontractors?

2. What would be the implications of this market power for allocative and dynamic efficiency in building and construction projects?

Market Power

- In a first-price sealed-bid auction where the number of bidders is unknown and bidders are risk averse, the expected revenue to the seller is greater if the actual number of bidders is concealed.

- Game theory suggests a risk-seeking subcontractor will be more likely to win work, at lower margins, if a contractor does not reveal the number of subcontract bids they receive.

Marginal Cost

- This suggests contractors might be more focused on extracting as much surplus from subcontractors as possible, and they can do this through the bidding system used to award contracts.

- If the subcontractor, or supplier, has no or little direct competition that firm will be able to negotiate favorable terms.

- However, if subcontracts are put out to tender and the number of bidders is unknown, the winning bid will typically be below the market price, and also below marginal cost.

Conclusion

- The use or abuse of market power is the core issue, and the standard approach to it is analysis of relative prices, typically using the Lerner Index to look for evidence of price manipulation in monopolistic or oligopolistic markets.

- However, there is a much smaller literature on monopsony power and even less on market power in the context of auctions.