

Tuesday, November 1, 2005. Issue 3286. Page 10.

Fair Auctions 101

By Konstantin Sonin

Ukrainian President Viktor Yushchenko scored a major victory last week when the government auctioned off the Kryvorizhstal steel mill for more than \$4.8 billion despite the protests of the opposition and a series of legal challenges filed by the winners of an auction held last year. Competition among the bidders was so intense that the mill sold for twice the opening price and more than five times what it went for in 2004, when a consortium led by former President Leonid Kuchma's son-in-law Viktor Pinchuk bought Kryvorizhstal for \$850 million.

The sale was a political victory over Yushchenko's domestic opposition, especially when you take into account that the privatization effort was spearheaded by former Prime Minister Yulia Tymoshenko. By holding a normal privatization auction, Yushchenko also achieved something that his rivals in Russia have never managed to do.

Politics aside, a number of purely economic lessons can be drawn from the Kryvorizhstal auction. The most interesting of these is the impact it will have on the metals market in the Commonwealth of Independent States, but this will not become clear for another few years, so let's focus on the economics of the auction itself.

There are two main dangers involved in holding a privatization auction of this sort: collusion between the bidders and corruption among the organizers. Collusion is a particularly serious problem because in certain circumstances bidders don't even need to form a secret alliance in advance. They can bid in such a way that a ring or alliance takes shape in the course of the trading session. The second danger is that the organizers of the auction set the rules in a way that gives one bidder a clear advantage.

Foreign bidders, including Russian companies, were effectively barred from participating in last year's Kryvorizhstal auction on the usual pretext of defending national interests. Restrictions of this sort, like collusion between the bidders, result in less profit than if the auction had been conducted on the up-and-up. Auctions run by the state are particularly vulnerable to both collusion and corruption because the government officials in charge have little incentive to encourage aggressive bidding or to secure the highest price.

The key to the success of last week's auction was allowing foreign steel producers to participate. This reduced the risk of collusion because it becomes harder to form alliances as the number of bidders increases. It also limited the risk of corruption by decreasing the advantage to be gained by cutting a deal with the organizers.

In theory, ascending-bid open-format auctions, where bidders successively raise the sale price until just one bidder remains, are more susceptible to collusion than sealed-bid auctions. But sealed-bid auctions are more vulnerable to corruption because bidders are often ready to part with considerable sums in order to find out how much their rivals have offered.

So what can Russia learn from the Kryvorizhstal auction? Surely the organizers of the Yuganskneftegaz and Slavneft auctions, as well as the privatization auctions of the 1990s, understood how corruption and collusion reduce profits. The lesson of Kryvorizhstal is for the Russian people, not the bureaucrats. And what it teaches us is that if the state holds a privatization auction but doesn't broadcast the bidding live, and disqualifies a major bidder to boot, you can bet that corruption and collusion are involved.

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