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The contractual and administrative regulation of public-private partnership☆

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ABSTRACT

Public-private partnership (PPP) contracts have been extensively used in developing countries as a device of promoting and attracting private investment to network industries. PPP contracts typically define rights and obligations regarding the design, build, operation and maintenance of infrastructures and the mechanisms for their supervision but also may include provisions about tariffs, access and interconnection rights or levels of service, conditions that are conceptually considered as economic regulation. Literature (Stern (2003)) has emphasized that the use of such contracts in the developing world, has permitted to mitigate the risks associated with the administrative intervention of governments on private investment, being important in the analysis of these risks to distinguish between economic regulation from other types of contractual obligations. This paper presents empirical evidence from a developing country, Peru, which identifies the factors that influence the decision to incorporate economic regulation in PPP contracts, from a sample of 65 transport infrastructure, energy and telecommunications projects. The results show that factors such as the risks of demand, the scale of the projects, the source of financing and technology have influenced significantly in governments' decision of including economic regulation provisions in PPP contracts. These findings, the evolution of private investor's perception on regulatory risk and the indicators of stakeholder's satisfaction with PPP model, suggest the need to outweigh the 'certainty' guarantees provided by contractual regulation with the transparency and accountability attributes of administrative regulation.

1. Introduction

Economic regulation, traditionally defined as the intervention of the State in order to mitigate or reduce the market power in network industries, has been the subject of an extensive theoretical and empirical literature. However, the specific legal mechanisms used to introduce or modify obligations and restrictions on the behavior of private agents in terms of rates, conditions of access or service levels; has been a topic less studied and analyzed. Literature (Stern (2003), Stern and Holder (1999)) has associated the widespread use of public-private partnership (PPP) contracts in developing countries, with the need to attract investment for the provision of infrastructure, reducing the perception of risk associated with the administrative intervention of governments. In this context, a common practice consisted of designing contracts that include provisions referring variables related to economic regulation, like rates, access and interconnection conditions or levels of service. An alternative scenario can be the administrative approval of regulations. The authority in charge of enacting these regulations is typically an independent regulatory agency, but in some cases can be a Ministry or other public organizations.

The evaluation of the determinants of the use of either of those mechanisms for the establishment of regulatory obligations has been seldom discussed by the literature. While some studies have asserted that in certain institutional contexts, the use of contracts can mitigate the risks associated with the administrative intervention, others have suggested that contractual regulation in the long term can reduce contract the flexibility usually required to adapt the terms to contexts of changing technological or economic conditions. On the other hand, depending on the institutional context, the use of contracts or administrative rules to control the power of the market in network industries, may offer different standards of transparency, participation and accountability. This is especially important to ensure the sustainability and the legitimacy of the regulatory system in long-term.

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Analysis performed by literature on the determinants of contractual and administrative regulation has been mainly qualitative and consisted of case studies. This article presents an analysis applied to a developing country, Peru, which for a first time, shows empirical evidence on the determinants of contractual regulation from three sectors subject to economic regulation: transport infrastructure, telecommunications and energy in Perú. This analysis represents to our knowledge, the first empirical attempt to quantify the relative influence of economic, informational and technological factors on the decision of regulating through contracts rather than through administrative mechanisms. Using a logit model, the general results confirm that there exist a positive association between the inclusion of contractual regulation and the magnitude of risks faced by concessionaires in the context of PPP. Indeed, our analysis shows that the inclusion of regulatory obligations in PPP contracts is determined by the technological characteristics of industries, the scale and the complexity of the projects, the source of funding (public or private) and the demand risks associated with projects.

The next section presents a review of the literature. The third presents the Peruvian institutional framework related to PPP during the last twenty years and the differences in the regulatory framework corresponding to the sectors of transport, telecommunications and energy infrastructure. In a fourth section, shows an empirical evaluation of the determinants of the introduction of tariff, access and interconnection and service level regulations, in 65 concession contracts corresponding to the sector transport, telecommunications and energy. Finally, we include some remarks about the need for a more flexible and balanced approach, combining the 'certainty' guarantees provided by contractual regulation with the transparency and accountability attributes of administrative regulation.

2. The debate on the use of contracts *versus* administrative rules for regulating networks

Demsetz (1968) criticism to the traditional notion of regulation was based in the assertion that *ex-ante* or '*competition for the market*' could become a substitute of economic regulation. According to this author, the use of auctions in order to allocate competitively the right to serve a market, can reduce or eliminate market power, being a more effective and less costly mechanism than the traditional economic regulation. According to this argument, once the right to serve the market is awarded, the role of the Government only consists of enforcing the terms established in the contract.

Williamson (1976) in a case study applied to the cable industry in Oakland, illustrated the problems of applying the Demsetz's approach in the context of long-term contracts, concluding that factors such as the incomplete nature of the contracts, uncertainty and the emergence of opportunistic behavior '*ex-post*' can, in the absence of intervention by a regulator, reverse the efficiencies achieved through the auction. Hence, Williamson (1976) holds that even in the case of contracts allocated via auction, regulation is necessary as a mechanism of control of market power, being a complement rather than a substitute of auction-based schemes.

In general terms, the administrative regulation is performed by the State through the adoption of general or specific rules and the use of coercive power to enforce them. According the European legal tradition these powers are known as the *Ius Imperium* of the State. These powers allow a Ministry or a State agency to approve regulations related to rates, access, interconnection or standards of service, among others, as well as to establish the means for their enforcement.

On the other hand, the State has procurement capabilities that can be used to acquire goods and services necessary for the fulfilling of functions established by the Constitution and the laws. Such contracts even though may contain some elements of private contracting regimes, are not completely comparable to these. In particular, procurement carried out by the State is governed by the principle of legality and, accordingly, must be framed within the limits of the provisions of the Constitution and the laws. This occurs, for example, in the case of PPPs, in which the Government's role is subject to the provisions established by the legal framework. However, this does not prevent that PPP could adopt certain figures taken from the private contracting and to provide guarantees that encourage the participation of private companies in the provision of infrastructure services. In some countries, the laws, the constitution and international treaties set different provisions that states principles and procedural frameworks for the protection of investments. These frameworks constrain, in greater or lesser extent, the discretion and the ability of the State, as a counterpart to a contract, to modify terms or to neglect the rights and obligations established in the contract. These restrictions to the scope of action of the Government in PPP can make more attractive for private investors to the extent that the use of these contracts can mitigate the risk associated with the discretionary intervention of the State.

Even when the use PPP contracts reduces the risk perception of private sector regarding the scope of administrative intervention, it is important to note that some of the terms and specifications included in such contracts may refer to economic issues that can affect the interests of third parties. Indeed, tariffs can affect the users' economy. As well, access rates can affect the competitors or the network users' ability to compete. Quality of service can also affect consumers and the performance of other technologically-related markets. In order to protect these third parties interests and 'public interest', Government role in PPP contracting it is typically constrained and framed within the limits of the laws and Constitution.

As can be noted, governance characteristics of administrative and contractual regulation differ substantially. Contractual regulation obligates both parties to accomplish equally with the provisions established in the contract. Any further change requires the consent of both, concessionaire and Government. In contrast, even though participative and transparent decision mechanisms can be established by the Government, administrative regulation as well as its subsequent modifications is performed uniquely by the public administration (typically a regulatory agency). Once the administrative regulatory rule is set, the concessionaire is compelled to accomplish with it and the regulator is obligated to enforce it. Given these sharp differences, the literature has debated on the strengths and weaknesses of both governance structures, evaluating if the two can be considered substitutes or complements. If the possibility of such complementarity is admitted, the discussion has focused on how those two different governance structures can interact in order to improve the performance of the regulated industry.

The discussion on the strenghts and weaknesses of contractual and administrative regulation is related not only with the process of introducing and approving regulation but also with the mechanisms of changing or modifying rules. One of the most controversial and debated issues of contractual regulation has been renegotiations. Literature (see for example Guasch et al. (2003, 2006 and 2009), De Brux (2010) or Ruiz (2015)) has emphasized that while renegotiations can be a natural consequence of the incomplete character of long term contracts, the lack of transparency and accountability in such processes in contexts of weak institutions can be a source of opportunistic behavior or corruption. For this reason, literature has highlighted the importance of strengthening the regulatory institutions including, among others the creation of autonomous agencies, in order to promote a more transparent and accountable regulatory framework. A direct implication of this debate

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