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Why not regulate PPPs?

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ABSTRACT

Regulation of public utilities and infrastructure is being generalized worldwide. However, when there are public-private partnership arrangements, it is assumed that the contract signed by the parties is adequate to protect the public interest, and therefore, external regulation is not necessary. Even though explicit regulation also has its shortcomings, we disagree with the preconceived idea that contracts alone always protect the public interest. Contracts avoid the discretion left to regulators, but they are imperfect and incomplete. Therefore, we defend the need for regulation and posit that it should be combined with a contract, resulting in a game of positive sum.

1. Introduction

The seminal article of Harold Demsetz, published in 1968, raised the question of the regulation of utilities (Demsetz, 1968). He argued that if it is possible to write all the duties (and the rights) of the parts (public and private) in a contract, and if there is enough competition for the market, the contract solution would avoid regulation, which is costly, discretionary and sometimes captured. It would also reduce the excessive rents usual in infrastructure and public services with market power (Bajari et al., 2009). Although not explicitly assigned to him, Demsetz might be considered a pioneer of the PPP (public-private partnership) arrangement. The major principles of PPP contracts applied to infrastructure worldwide include the possibility to regulate the relationship between public and private partners of an infrastructure and/or public service using a contract and the guarantee of normal profits by eliminating the monopolistic rents through competition for the field (e.g., by public tender). However, the same benefits noted by Demsetz are simultaneously the major shortcomings emphasized by other well-known authors, such as Oliver Williamson, Victor Goldberg and Oliver Hart. They identify the incompleteness of contracts because it is difficult to write complete contracts that predict and include all possible contingencies (Williamson, 1976; Goldberg, 1976; Hart, 1988). Furthermore, they also highlight the distortion of competition in the infrastructure sectors where the market power is usually great and normally few companies compete, the long time and cost of the public tenders, which can take several years, the complexity of the award process when several criteria are adopted (Crew and Zupan, 1990) and the struggle to monitor, supervise and enforce the service standards (Cruz and Marques, 2013a). For example, the quality of service is multidimensional (results of variations in stated preferences) and changes in time; therefore, it is nearly impossible to predict the adequate quality of service for 30 years or more in a written contract. The award process is always controversial as well as time and cost-consuming (Marques and Berg, 2010). In England, the privatization of the electricity sector for the entire country was prepared in a few months and the documentation involved comprised 214 pages, while the contracting of the electricity service of the London underground took 3 years, cost £15 million and comprised 2500 pages (Littlechild, 2002).

Most of the infrastructure sectors are dominated by a limited number of transnational companies (e.g., in water and sanitation, Veolia, Suez and Aqualia or in urban transportation, Arriva, Stagecoach and Transdev) or the strong local firms drive out the other competitors (e.g., Foz or CAB in the water sector in Brazil or the national champions in the Southern European motorways), and therefore, the type of competition that truly eliminates excessive profiting does not exist in these areas and the asymmetric information and know-how differences between these companies and the public authorities are huge. Furthermore, the risks involved in these contracts are numerous, not only because of the weak preparation of the tender packages and the required up-front investments but also because of the hypothesis of ex-post

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opportunism by the governments and the constraining 'political' risk involved (Marques and Berg, 2011). Hence, sooner or later, PPP contracts in infrastructure enter into a renegotiation process (Guasch, 2004). Thus, both the authors mentioned and the historical data have shown that some kind of regulation is required for these PPP contracts. In some countries, the solution for these issues has been delegated to the contract manager, who is a sort of regulator, but who is a part of the public sector (examples are found in Australia, the UK and Canada). We argue that contract management is important and required but that it is not enough because it is not (nor should it be) independent, and therefore, some type of external regulator is essential. This paper will address the need for regulating the PPP contracts. In it, we respond to the following research topics: Does competition for the field can avoid regulation of PPP contracts? Is contract management of the PPP arrangements enough? or do PPP contracts require contract management and independent regulation simultaneously? As far as the authors know, this matter has not been discussed in the literature, but investigating it in detail is useful for both academics and practitioners. The paper is organized as follows. After this brief introduction, section two discusses the market failures in the infrastructure sector and the corresponding contract failures when regulation is absent. Section three justifies the need for contract management of the PPP contracts and section four argues that contract management is not enough. Section five justifies the need for regulation. Section six presents some empirical examples from two different countries and section seven presents the major conclusions of the study.

2. Problems of PPP contracts in infrastructure

Infrastructure and its associated public services generally experience market failures for a variety of reasons (Baldwin and Cave, 1999), such as asymmetric information (moral hazard and adverse selection), externalities (positive and negative), provision of public goods or quasi-goods (with social value that is greater than their financial value), excessive market power, monopolistic features and the production of undesirable results (increasing the lack of economic and social cohesion). Furthermore, as a rule, infrastructure and its associated public services demand a large up-front investment that tremendously increases the risk involved and are very prone to ex-post opportunism by governments (Vickers and Yarrow, 1989). Because they provide essential services or facilities that affect the collective needs of the public, they are politically sensitive. Thus, politicians, who are often considering the electoral cycle and are guided by patronage rather than the infrastructure life and sustainability, may breach their commitments (Berg, 2013). These features require the existence of explicit regulation. Both the economic literature and the historical data show that this is reasonably well-accepted by governments and decision makers, primarily in network industries (e.g., electricity utilities and fixed telecommunications) and, to a lesser extent, in transportation and water utilities, irrespective of their ownership (e.g., private companies or state-owned companies). Regulation is implemented to mitigate or correct these market failures, miming the market, to defend public interest and social welfare (Viscusi et al., 2005).

Similarly, these market failures that demand regulation remain when PPP arrangements are developed. They can even be exacerbated because imperfect contracts can increase the failures of the 'infrastructure markets' (Cruz and Marques, 2013a). On the one hand, the rules are defined and the capacity to intervene, in general, is shorter. As discretion is curtailed, there is no flexibility to adjust to unexpected contingencies or to newly arising needs. This complex environment leads to an ex-ante gaming strategy (Burger and Hawkesworth, 2011) by the competitors accessing the market (underpricing and optimistic bias leading to the winner's curse (Reeves, 2008)) and to ex-post opportunism by the winner forcing renegotiation, which by its nature and usual lack of transparency, almost always damages the public sector (Guasch, 2004). On the other hand, when the contract is signed and the infrastructure or public service is constructed or transferred to the private company, the public party frequently 'forgets' its role as owner and contract manager and, therefore, does not follow-up on the compliance of the contractual obligations, thus losing all familiarity of the infrastructure or public service functions (Marques and Berg, 2011). This reality, which increases asymmetric information, places the public party in an unfavorable position when the contract is renegotiated (Bajari et al., 2006; Brux, 2010). Actually, infrastructure or public service management can be delegated to an external company but not the ultimate responsibility for it (Marques and Berg, 2010). Unfortunately, the historical data contain many such examples (Soomro and Zhang, 2015; Williams, 2010). This type of contract failure is likely to be more serious than the market failures and the intervention of the regulator might be even more necessary in this case (Diaz, 2016).

3. The need for contract management

Because it is impossible to write 'perfect' and 'complete' contracts, the contract should, at minimum, describe how it will be administered and managed by the parties (UN, 2006). Therefore, the public party should be represented by someone (a small commission or even one person) to interact with the private party in the day-to-day execution of the contract. As stated above, one of the major contributors to the failures of PPP contracts is the lack of the public party engagement in the PPP contract after award, which, unfortunately, is the norm (Stern, 2012). Moreover, before signing the contract, the parties should agree on the terms of the contract management manual (Partnerships Victoria, 2003). The terms should be outlined in a document that systematizes the relationships, the procedures and the actions between the parties during the contract execution. Contract management, among other aims, helps to a) ensure compliance with the contractual clauses and defend their stability; b) ensure compliance with the objectives of the project and guarantee the public interest; and c) keep a constructive and healthy relationship with the private partner. Fig. 1 illustrates the three major domains of contract management, i.e., the administrative management, the operational management and the relationship management (Cruz and Marques, 2013a). All of them are important and decisive in the attainment of the project goals. Furthermore, they involve different domains which increase considerably the complexity and the difficulty to accomplish this task efficiently. Fig. 2 shows the major activities involved in PPP contract management (Cruz and Marques, 2013a). In the view of the authors, these activities can be categorized into internal and external activities, depending on the focus. Internal activities focus on the internal processes of contract management and are more instrumental. External activities are aimed at the outside, intervening directly with the project performance. In the figure, they correspond to the inner and outer orbits. Internal activities include contract governance, information analysis and collection, contract administration and regular reviews. External activities include the management and the solution of conflicts and problems (Edkins and Smyth, 2006), information management, knowledge management, performance monitoring, contingency planning and the management of change. The need and demand for these activities are completely different from the traditional public procurement of public works because the duration and complexity of the contracts, which involve not only the construction of the project but also its

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