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How Investor Portfolios Shape Regulatory Outcomes: Privatized Infrastructure After Crises

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Summary. — Many developing countries privatized utilities during the 1990s. Their weak institutional environments, however, make them prone to crises that generate incentives for governments to renege on contractual commitments to investors. To understand variation in post-crisis regulatory outcomes in such contexts, scholars must consider investors' prior choices regarding portfolio structure. Investors facing high reputational costs from exit are more likely to remain following expropriation, and those holding diverse assets in their contract jurisdiction, to secure compensation. These factors account for significant unexplained within-sector and subnational variation, for which we provide qualitative and quantitative evidence from Argentina's water and electricity sectors following the 2001 crisis.
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1. INTRODUCTION

Large literatures in comparative and international political economy examine the circumstances under which states can guarantee property rights and protect investors from political risks. Most analyses emphasize the importance of strong domestic institutions or international agreements that can serve as "substitutes" for such domestic institutions: scholars have argued that checks and balances (e.g., Henisz, 2002; North & Weingast, 1989), certain regime types (e.g., Jensen, 2003; Li & Resnick, 2003), and investment agreements (e.g., Büthe & Milner, 2008; Elkins, Guzman, & Simmons, 2006; Neumayer & Spess, 2005), help governments provide "credible commitments" to protect property rights and are thus associated with higher rates of investment and economic growth.[1]

This scholarly emphasis on institutions that provide credible commitments builds upon a classic literature in political economy that highlights important non-institutional sources of variation in political risk and business leverage. Kindleberger and Vernon famously argue that investors in capital-intensive sectors face an "obsolescing bargain" in which governments can renege on original commitments once firms have invested in fixed capital (Kindleberger, 1969, pp. 149–151; Vernon, 1971, pp. 46–53). Similarly, political scientists suggest that investors whose assets are immobile and cannot credibly threaten to exit exert little policy influence (Bates & Donald Lien, 1985, p. 61; Jensen, 2006, p. 3; Lindblom, 1977, p. 180; Winters, 1996).[2]

In this paper, we argue that while the classic focus on asset immobility and more recent emphasis on institutions offer important insights, scholars must examine additional non-institutional sources of variation to understand political risk and business leverage in weak institutional environments, especially the impact of firms' prior investment decisions on their subsequent bargaining power. This focus helps explain within-sector and within-country variation that these dominant approaches cannot explain. The infrastructure and utilities sector illustrates why this is the case. During the 1990s, dozens of developing countries privatized these services, expecting that multinationals would bring much-needed funds and technology: 133 low- and middle-income countries privatized state enterprises in the telecommunications sector, 107 in the energy sector, 82 in transportation, and 61 in water and sanitation during 1990–2009 (PPIAF-World Bank, n.d.). Governments typically structured these privatizations as long-term contracts so as to allow investors sufficient time to recoup significant upfront expenditures in system upgrades and expansion. Much of the existing literature on utilities and infrastructure privatization has focused on the political rationale for privatization and its welfare effects, rather than on regulatory politics following privatization.[3]

Institutionalist perspectives suggest that private firms' infrastructure and utilities privatization contracts in weak institutional environments would be particularly vulnerable to the obsolescing bargain. Most developing countries have weak political institutions that accentuate economic volatility and susceptibility to crisis (Acemoglu, Johnson, Robinson, & Yunyong, 2003). Investors in utilities and infrastructure are particularly vulnerable to economic crises, which provide governments with incentives to renege on original contractual terms (Post, 2014a). Because utility services are consumed by

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the majority of the population (Levy & Spiller, 1996), whose living conditions deteriorate as a result of crises, elected officials focusing on their political survival in the short run are sensitive to calls to revise contractual terms to the detriment of firms (Henisz & Zelner, 2005, p. 370); meanwhile, in weak institutional environments, governments face few barriers to responding to such political pressures.

Standard political economy approaches suggest infrastructure investments are particularly vulnerable in weak institutional contexts—to such an extent that recent scholarship on the obsolescing bargain suggests all firm-government negotiations will take place prior to market entry (Jensen *et al.* (2012, p. 16)). Yet there is significant variation in investor experiences following crises within single countries and sectors. For example, the Argentine government suspended all utility contracts and nullified the exchange rate guarantees they contained during the 2001–02 crisis, thereby reducing investor earnings in dollars by *two-thirds*. The post-crisis status quo thus marked a decided setback for investors. However, in the water and sanitation and electricity distribution sectors—both characterized by large sunk costs—investors varied in their willingness to continue operating in the country and in their subsequent ability to secure compensatory policies to help them adjust to post-crisis realities. One-third of these investors remained in the market until the end of 2009. Meanwhile, one-quarter of the investors present when the crisis hit eventually reached agreements with government authorities providing for rate increases, reductions in investment obligations, and state investment subsidies designed to compensate them for the devaluation and the government's suspension of contracts during the crisis. Scholarship on investor-government negotiations following the Asian financial crisis suggests that such variation is not unique (Wells & Ahmed, 2007, pp. 267–269).

In light of this significant and unexplained variation, we argue that it is important to consider not only levels of capital-intensity and institutions, but also how investor portfolios affect probabilities of market exit and success in negotiations with host governments following expropriation. We highlight two particular aspects of portfolio structure: *reputational exit costs* and *cross-sector diversification* within the contract jurisdiction. These portfolio characteristics vary across contracts, rather than only across countries or sectors, and thus add significant analytic leverage to existing theories.

Consistent with existing theories, we expect that exit costs associated with investments in physical capital will increase investor willingness to stay in the market. However, we also highlight the importance of the *reputational costs of exit*, which can vary significantly within capital-intensive sectors. Investors should be less likely to exit when their reputations with other domestic political actors, foreign governments granting new contracts, and international markets would suffer following departure.

Reputational exit costs, however, do not mitigate the obsolescing bargain. Firms are more likely to obtain policy concessions when they are diversified across sectors *within* the political jurisdiction that granted an infrastructure contract. *Cross-sector diversification* should increase the probability of reaching pro-investor agreements by opening up a wider set of possible negotiation outcomes—including those involving compensation for firms' losses through side-payments that benefit other operations—that may be more politically viable. While such agreements may be technically legal, they may also involve crony capitalism. Sector diversification can also augment firm leverage by increasing the firm's access to information, relevant social and political ties, and opportunities to influence local economic conditions and the quality of other services.

We provide an initial test of our argument's explanatory power through case studies and quantitative analysis in Argentina following its 2001–02 economic crisis. Drawing on an original dataset, we analyze the experiences of 53 investors holding majority stakes at some point in time in the 30 provincial and national contracts in the electricity distribution and water and sanitation sector. Argentina represents an ideal case because one can employ a comparative, subnational research design that controls for the type of economic shock, privatization program design, and government concerns about its international market reputation. During Argentina's post-crisis period, it is straightforward to measure our dependent variables, investor exit, and policy concessions to firms. The national and provincial governments' decision to suspend existing contracts following the crisis hurt all investors, who subsequently sought contract renegotiations to relieve them of some of the burden of post-crisis adjustment and considered exit when agreements were not quickly forthcoming. Because contract renegotiations followed a common template and, when reached, improved upon the post-crisis status quo for firms, they provide a rare opportunity to examine the conditions associated with agreements partially compensating investors for expropriation.

In the next section we present our analytic framework. We then explain our research design and data collection strategy. The following sections present our case studies and the quantitative analysis of the patterns of market exit and contract renegotiation for all provincial and national electricity distribution and water and sanitation concessions in Argentina. The last section discusses the broader implications of our findings.

2. BARGAINING UNDER DURESS: PORTFOLIO STRUCTURE AND REGULATORY OUTCOMES

In weak institutional environments, utilities and infrastructure contracts are incomplete; economic or political shocks provide prompts for renegotiation. Shocks such as economic crises often trigger shifts in economic fundamentals and prompt governments to enact policies that are detrimental to investors. Post-shock contract renegotiations occur between two parties, a host government and the lead investor. [4] We assume firms are interested in policies that improve their operating environment and profitability relative to the status quo. Host governments, in turn, prefer renegotiation agreements that are low visibility (e.g., that avoid immediate and large price hikes), that are not reached during competitive elections that increase their salience, and that avoid transferring responsibility for politically risky or deficit-ridden services back to the public sector. [5]

Standard political economy approaches suggest that investor patience and leverage in firm-government negotiations will vary with the institutional environment and degree of capital intensity. We provide additional analytic leverage through a complementary emphasis on investor characteristics, following the international business literature. While the international business literature has focused on factors like joint venture ownership (e.g., Henisz, 2002), investor origin and longevity in the market (e.g., Zaheer & Mosakowski, 1997), and business association membership (Pyle, 2009), we examine how investor portfolios affect (a) investor willingness to stay in the market following expropriation, and (b) if investors secure policy concessions.

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