



# Mitigating expropriation risk through vertical separation of public utilities: The case of Argentina



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## ABSTRACT

In 2002, Argentina devalued its currency and froze public utility rates thus breaching the guarantees granted to investors the decade before. Those guarantees had lowered investors' cost of capital by substantially reducing expropriation risk. This paper looks into the governance structure chosen by Argentina for the privatization process and potential alternatives after a decade of contract breaches. Future governance should be market-oriented, involving vertically separated companies with former public utilities voluntarily acting as operating companies or OpCos, and NetCos in charge of all network expansions under the structure of PPPs created for such purposes.

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## 1. Introduction

Transaction-cost theory (Williamson, 1975, 1976, 1979, 1985) identifies the most economical type of governance for a given business transaction. When applied to public utilities, this theory would stipulate that the efficient level of investment (*i.e.*, the one that maximizes welfare) in durable, transaction-specific (non-fungible) assets<sup>1</sup> can be achieved by private companies (as opposed to the government) only if the government can convince the private investor that it will not act opportunistically by expropriating the investments once sunk. This is normally achieved by providing private investors with guarantees in the form of contracts that become more complex and expensive in terms of design and enforcement (*i.e.*, higher transaction costs) the more transaction-specific the asset involved and the higher the uncertainty surrounding the future transaction. In extreme cases when an

expropriation has already occurred, such as in Argentina, the guarantees that would be necessary to convince investors to make a new investment in a transaction-specific asset may not only be extremely costly to implement and onerous to end users, but it may also be counterproductive, exacerbating expropriation risk and inducing a new contract violation. This new breach could take on two forms, namely: a direct taking of the assets by the government (*i.e.*, a direct expropriation or a nationalization of the company) or a subtler one through either a change in the regulations governing the contract or the freeze of the company's regulated tariffs (*i.e.* an indirect expropriation). Investors, anticipating this new contract violation, would stop investing for fear of not being able to recover the investment, which would ultimately lead to the breach occurring sooner, justified now by the actual underinvestment.<sup>2</sup>

In this particular case, transaction-cost theory would indicate that the only way to achieve the efficient level of investment would be through a vertically-integrated, government-owned service provider, given that no private investor would be willing to invest under these riskier conditions. The goal of this paper is to demonstrate that there is an alternative type of governance to

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<sup>1</sup> Williamson (1979: 239–241) argues that when a buyer induces a supplier to incur in a transaction-specific (non-marketable) capital expense, both parties become locked into the transaction, thus forming a bilateral monopoly: the buyer, who has no alternative sources from which to buy the final product, and the supplier, who may become subject to the buyer's opportunism when bargaining over the gains from trade.

<sup>2</sup> Alternatively, even without underinvestment by the company and with cost-based rates a future government might decide to go ahead and expropriate the company anyway for political reasons alleging that the rates set by the previous government were too high.

government vertical integration that minimizes the risk of a future expropriation but, unlike the governance in Argentina in the nineties, does not involve providing guarantees to the private investor. Under the proposed model of vertical separation between OpCos and NetCos, guarantees are no longer necessary as the former public utility company (*i.e.*, now the OpCo) is no longer responsible for investing in network expansions. Now, the obligation of financing, booking and recovering investments in network expansions lies with NetCos, which would operate under the structure of Public Private Partnerships (PPP) such as Fiduciary Funds, Special Purpose Vehicles (SPV), or public companies thus eliminating the risk of opportunistic behavior by the government.

## 2. Transaction costs, asset specificity and governance

While the importance of transaction costs, as it relates to optimal firm size, was first introduced by Coase (1937), it was Williamson (1975, 1976, 1979, 1985) who defined what transaction costs are and how they affect the vertical structure of a given industry. Williamson defined these costs as those related to negotiating the terms of a contract between the parties, such as drafting the contract, designing the mechanisms to enforce it, and carrying out this enforcement. According to Williamson, these costs become particularly important the more specific the asset's purpose in the production of a good (*i.e.*, the fewer alternative uses for the asset once the investment has been made), the more uncertainty exists about the future transaction, and the more frequently the transactions involving the asset occur.

Assuming, for the moment, a certain frequency in the transactions, the theory indicates that the more specifically the asset relates to the production of the good and the greater the uncertainty surrounding the future transaction, the more the safeguards required by the producer from the purchaser prior to making the investment. This is because once the producer has made an investment (which is therefore sunk), the buyer will have every incentive to appropriate the quasi-rents generated by the transaction by decreasing the purchase price of the good.<sup>3</sup> Since producers do not have, *ex-post*, an alternative use for their investment, they would have no choice but to accept the price offered by the buyer as long as the price can cover average variable costs. This is why, before making the capital investment, producers will normally require *ex-ante* guarantees that their investment will not be expropriated, *ex-post*, through the buyer's reduction of the purchase price of the goods.

Guarantees to the producer normally take the form of detailed contracts that specify each of the measures or actions to be taken depending on each of the expected contingencies that may occur in the future.<sup>4</sup> The greater the uncertainty surrounding such contingencies or the greater the number of expected contingencies, the more complex, lengthy and costly the design and enforcement of the contract will be, and the higher the compensation to the aggrieved party in case of a contract breach. Obviously, the higher these transaction costs, the greater must be the expected return on the investment to justify incurring them.

<sup>3</sup> Klein et al. (1978: 298) define quasi-rents as the value of assets in excess of their recoverable value (*i.e.*, salvage value) and is calculated as the revenues generated by such assets net of operating costs and the recovery value if a third party rents the asset. This value must be greater than or equal to the depreciation of the specific fixed asset for investors to recover their entire investment.

<sup>4</sup> Williamson (1979: 237) indicates that such contingencies cannot be foreseen while designing the contract and that the measures to be taken for each of the explicit contingencies might not be apparent until those contingencies materialize in the future, thus increasing uncertainty.

## 3. Argentina's privatization and regulatory paradigm of the nineties

Argentina's public utility privatization process began in the early nineties and involved the transfer, in the form of concessions and sales, of the assets necessary for the provision of public services such as water supply and sewerage, electricity and gas distribution, and transportation. Typical characteristics of these companies include: a) the services provided are essential and consumed in mass scale by the population; b) the operations have large economies of scale (high fixed costs with diminishing average production costs) and scope; and c) these economies of scale and scope are normally generated by highly specific asset investments that do not have an alternative use once sunk (*e.g.*, power grids, water and natural gas networks, etc.).<sup>5</sup>

These technical features are the essence of the governance problem in public utilities. They define the sector's optimal vertical structure<sup>6</sup> and subject the investor to the risk of governmental opportunism, or hold-up risk, which is defined as the government's incentive to renege on its original commitment by appropriating the quasi-rents generated by the service providers (*e.g.*, through a direct expropriation of the assets or indirectly through a tariff freeze) once the investments have been sunk. For this particular case in which a) the investments are highly specific with no alternative use, b) the companies face a high frequency of transactions with buyers, and c) the privatization process is subject to a high degree of uncertainty, Williamson's taxonomy would recommend a bilateral governance structure. The government would act as the regulator, and the private company would provide the service; the two parties would be linked by complex contracts (*i.e.*, highly detailed lists of possible contingencies and subsequent actions) acting as guarantees (*i.e.*, transaction costs) that the sunk investments will not be expropriated by the government.<sup>7</sup>

In the early nineties, the Argentine government embarked on an ambitious privatization process within the framework of a sophisticated institutional architecture that provided this kind of safeguard to investors, thus reducing the risk of a potential expropriation. These safeguards included guarantees to investors, such as: a) bilateral investment protection treaties (BITs) signed between Argentina and several other countries that were ratified by the parliaments of all countries involved, giving investors the right to claim, before an arbitration court, the fair market value of their investment as of the date immediately prior to any expropriation or unfair treatment<sup>8</sup>; b) legislated regulatory frameworks<sup>9</sup> with US dollar denominated rates and automatic-adjustment mechanisms based on the US CPI and PPI, plus ordinary tariff

<sup>5</sup> See Spiller (2010: 149) for a more extensive discussion of the definition and characteristics of utilities.

<sup>6</sup> The one that minimizes transaction plus production costs according to Williamson (1979: 245).

<sup>7</sup> The justification for the use of bilateral governance in this case is that as a result of the privatization process, the potential welfare gains for the population and productivity gains for the economy as a whole were, *ex ante*, so large that they justified incurring high transaction costs in designing and enforcing complex contracts.

<sup>8</sup> The Bilateral International Treaty signed between Argentina and the U.S. states: "...Compensation shall be equivalent to the actual market value of the expropriated investment immediately before the expropriation action is taken, or when it becomes known, if this would have occurred first..." See Article IV of the Treaty between the United States of America and the Republic of Argentina on the Promotion and Reciprocal Protection of Investments.

<sup>9</sup> The federal Gas Act 24.076 and Electricity Act 24.065 of 1992. In the provinces where electricity distribution was privatized, laws similar to 24.065 were passed with the same tariff adjustment clauses. In relation to telecommunications (Decree 62/1990) and water (Decree 999/1992 and 787/1993), privatization was carried out with decrees that gave the same assurances as the gas and electricity laws.

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