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Why Are Developing World Private Finance Contracts So Difficult to Get Right? by M. Parish

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**WHY ARE DEVELOPING WORLD
PRIVATE FINANCE CONTRACTS SO DIFFICULT TO GET RIGHT?**

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Abstract

Contracts for private sector participation in the operation of infrastructure (“PFI contracts”) are, with some important exceptions, difficult to make work well in the developing world. It is enquired why this should be. The principal economic rationale for infrastructure privatisations – “Demsetz competition” - is reviewed. It is examined why that rationale may in some circumstances prove wanting. Market failures, enforcement problems, long contractual terms and regulatory weaknesses all hinder effective private participation. The conclusion drawn is that there are significant micro-economic obstacles to such contracts working, but those obstacles can be mitigated, and there are some strong collateral benefits to private sector participation, including financing “off balance-sheet” and the possibility for radical institutional reform. But in order to render such contracts more likely to succeed, greater attention needs to be given to aligning private sector contractual incentives with public sector goals when contracts are negotiated. Private sector bidders must understand the regulatory and institutional framework within which they will be operating if

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their bids are successful, and dispute resolution mechanisms must be tailored to the problems with which PFI contracts are beset. PFI failures are often the result of each party failing to appreciate the incentives and constraints motivating the other. The biggest cause of these failures is unimaginative public procurement methods. Furthermore, neglecting to plan adequately for resolution of disputes exacerbates problems when they arise. But there are lessons that can be learned to alleviate these problems, and the article concludes with a series of practical suggestions to increase the success rates of public / private partnerships in the developing world.

I. The problem described

One distinguishing feature of developing world economies is poor infrastructure. Water quality and supply, roads, public transportation, telecommunications and electricity services are usually of significantly poorer quality in developing world countries than in the developed world. As well as adversely impinging upon the quality of life of the citizens of those countries, poor infrastructure acts as an impediment to economic development, as businesses bear the inefficiency costs of poor communication, slow or expensive travel, and energy shortages. Poor infrastructure can also result in isolation of those communities with less access to infrastructure services than others (for example, remote rural areas, or poorer parts of urban areas), leading to social division or difficulties in exercising political control. Most development economists therefore agree that improving infrastructure is an important component of any programme to facilitate economic growth in the developing world.

Rendering those improvements is no easy task, because the causes of infrastructure failure are myriad and complex. Most developing world infrastructure networks are chronically under-funded, but paucity of resources is not the only problem facing them. Often the public sector institutions with responsibility for managing infrastructure networks are weak, suffering from a lack of technical expertise, a burgeoning bureaucracy and manifold layers of ineffective management. Corruption, outdated technology, poor incentives for staff to execute their employment duties effectively, and lack of accountability are also recurrent concerns. Civil servants are rarely recruited on meritocratic principles, and poor management culture discourages them from innovation, hard work or responsibility. Given poor salaries, and without effective enforcement of criminal laws, they may use authority corruptly for personal gain. Such an array of problems renders an anxiety amongst external donors that if extra funds are made available for infrastructure improvements, they will not be efficiently spent. Therefore the development challenge is to combine funding for infrastructure improvements with the necessary institutional changes to ensure that money will be used prudently to achieve sustainable improvements to infrastructure service quality.

One method of achieving institutional and efficiency gains in the operation of public infrastructure services, ever more popular in various forms since the 1980s, is to introduce private sector participation.¹ There are a variety of mechanisms for achieving this, which give the private sector a greater or lesser degree of legal control over the infrastructure resources. At one end, “pure” privatisation of infrastructure involves a

permanent sale of legal title in the infrastructure assets to one or more private buyers. (This can be achieved by a sale of shares in a special purpose corporate vehicle, or a direct sale of assets to the investor.) At the other end of the spectrum, management contracts are time-limited agreements under which the private partner manages the infrastructure resources for a fee, the calculation of which will often contain a performance-linked component. Under such an arrangement, legal title to the infrastructure resources remains entirely in the public sector.

In between these two extremes, a variety of recently developed novel contractual arrangements are used, variously called “private finance initiatives” (PFI) or “public / private partnerships” (PPP), amongst other names. These contracts (which for the sake of simplicity are called “PFI contracts” from now on) typically give the private sector company some long-term interest in the infrastructure assets, short of permanent ownership – say, a licence or concession, of several years’ duration. The terms of the licence will authorise exploitation of the infrastructure resources in certain ways, and permit the private sector partner to keep part or all of the income from so doing, in consideration of an initial capital investment or other front-ended charge, and minimum service commitments. Irrespective of the legal and structural differences between each of these models for private sector participation in infrastructure, the aim in each case is to tap into the perceived efficiency and institutional advantages that the private sector has over the public sector.

It is these contracts that are so patchy in their performance. The World Bank is the single biggest financier of such projects in the developing world; its experience suggests a mixed record of success. Outright failure is rare.² But serious problems are common.³ In a number of cases PFI contracts have collapsed in a wave of harmful publicity. Often, quality of service drops, as prices go higher and cost-saving measures reduce standards. There is a track record of PFI contracts being renegotiated under duress, or dissolving into litigation or arbitration: see e.g. Peterson (2004). In what follows, legal and economic explanations are developed for these phenomena, and an approach is suggested for tender and negotiation of PFI contracts that might mitigate the risk of their failure. This paper does not seek to give a descriptive account of particular privatisation projects that have failed or have recovered from distress.⁴ Instead, the aim is to explore some general reasons why there are so many failures, and to draw some appropriate lessons if the theory is correct.

II. The theory of privatisation, and its limitations for natural monopolies

Consider the following argument in favour of privatising infrastructure. When considering how to organise the management of an essential service, the paramount goal will be welfare efficiency: the highest standard of service is provided for the least cost to the consumer or taxpayer. One necessary precondition of welfare efficiency is the internal efficiency of the organisation providing the services: it cannot sustainably provide services at low cost to its consumers unless it can produce them at low cost to

itself. Modern microeconomics emphasises that one of the most important determinants of a business organisation's internal efficiency is the incentives of the staff who work for it: whether it is in the workers' direct (usually financial) interests that the organisation functions efficiently and achieves its goals at minimum cost (Laffont and Martimort 2002). Public enterprises are poor at aligning incentives of managers to achieve internal efficiency, due to lack of a direct profit motive on the part of those who exercise control over it. (Shareholders and directors are more immediately interested in profit than are politicians.) Therefore a private organisation is more likely to fulfil a necessary condition for welfare efficiency than is a public enterprise.

This argument contains an obvious lacuna. While internal efficiency is a necessary condition of welfare efficiency, it is a sufficient condition only where competition mandates price moderation. Infrastructure services are usually a monopoly or close to it, for reasons that will be explored below. In conditions of monopoly, the price to consumers will be considerably higher than where real competition exists. The monopoly price will be that at which a marginal increase in price by the supplier generates a marginal decrease in profits due to consumer substitution of the commodity for another. Where (as is often the case for infrastructure commodities), the commodity is hard to replace, and its demand curve is therefore inelastic (i.e. demand for the commodity does not vary significantly with changes in price), the monopoly price will be particularly high.

Monopolistic private enterprises will therefore charge excessive prices for their commodities, or (which amounts to the same thing) restrict their output, because this is their profit-maximising course of action.⁵ Research has also suggested that monopolists have perverse incentives to provide goods or services of a sub-optimal quality from the perspective of consumer welfare: Tirole (1988); Gabszewicz et al. (2002). Consumers cannot discipline a monopolist's conduct.⁶ It is only circumstances approaching perfect competition between private sector organisations that tend to yield welfare-maximising incentives.⁷ Under such conditions, there is an indefinite choice of suppliers, consumers are fully knowledgeable about the products and terms offered by competing suppliers, and can contract with, and change, their suppliers with zero cost. Consumers will shop with those companies that produce the highest quality goods or services at the lowest prices, thereby driving prices down to maximise welfare efficiency.

This model of private sector efficiency rarely fits the infrastructure paradigm, because infrastructure is often a natural monopoly: markets for which geography, technology or capital start-up costs render a monopoly inevitable. For example, it is usually thought unrealistic to have water sector providers compete to supply water to private homes, because there can be only one set of pipes, pumps and reservoirs, and those assets can be operated only by one organisation. The same is true of trains, because in practice there can be only one set of rails and rolling stock; capital costs, urban planning and geography serve as limiting factors. Until the recent advent of mobile telephones and sophisticated regulation, telecommunications was also a monopoly: substantial capital costs of establishing telephone exchanges and telegraph wires

precluded direct competition between service providers for consumers' demand. One might therefore ask what reason there is to believe that the efficiency gains from competition can be harnessed as a general rule in infrastructure sectors.

III. Competition for the custom of government, and its imperfections

The principal answer advanced in the developing world context⁸ is that "Demsetz" competition (Demsetz 1968) may exist between suppliers, not for the custom of private individuals, but for the custom of government, as a single consumer representing the totality of private consumers. According to this theory, the efficiency-inducing competition lies in rival bidders submitting tenders to the government for the operation of infrastructure services. The most efficient bidder will be able to offer the lowest consumer or taxpayers' charges, and will therefore win the tender. This theory is often presented as the principal market justification for PFI contracts (Riordan et al. 1987; Laffont et al. 1993 ch.s 7-8). The recent history of PFI contracts in the developing world might provides insights into what is wrong with this logic, and what can be salvaged from it. Consider the following problems, picked as representative of the types of difficulty this theory presents.

In practice the so-called competitive tendering process may be less than the ideal of perfect competition. There may be only a very small number of bidders.⁹ Infrastructure management in the developing world is a highly specialised field of expertise, and

country-specific experience is harder still to come by. And precisely because PFI contracts in the developing world have a history of unfortunate complications and intractable disputes, bidders may be sceptical about the profit opportunities available. Because bidders' knowledge of the country may be limited, their bids may be based upon unrealistic assumptions about revenue and returns. Because the number of bidders is likely to be small, the government may accept a bid notwithstanding a lack of demonstrable country-specific knowledge.

International public procurement typically proceeds by way of standard bidding documents and contracts. Sometimes the only item for serious negotiation is the size of the bid. (Were it otherwise, it is argued, a level procurement playing field for bids would be impossible, because it would be impractical to compare two bid prices given different contractual terms in each case.) This gives the private sector bidder an incentive to under-bid, and then (after being awarded the contract) subsequently recoup maximum profit through over-billing and under-expenditure. This may be achieved by exploiting whatever loopholes the contractor can find in the standard-form contract, rather than abiding by the spirit of a more carefully negotiated contract that has been tailored to the financial and political pressures facing each party (Williamson 1976).

Contracts for private participation in infrastructure are likely to be of significant length (in the order of several years), because the private participant will require an extended opportunity to recoup usually substantial initial capital investment. Throughout the contract term, there is no effective competition, save to the extent that the private

sector contractor is minded to seek renewal of its licence or concession as the contract draws to a close. (This incentive will influence conduct only towards the end of the contract, once it has already been concluded that the contract is a success and renewal is therefore desirable.) Therefore apart from the possible tail-end incentive to obtain renewal, front-end competition does not create an incentive for the private sector to perform the contract well.¹⁰

Variations on the perverse incentives characteristic of monopoly may emerge during the course of the contract, as the contractor engages in ex-post opportunism. The less elastic the demand for the infrastructure services (demand is usually inelastic, because there is no practical similar-cost alternative to using water, roads, telephones or electricity), the more will private sector service providers be motivated to cut costs given a static contractual revenue stream, leading to deterioration in quality.

Remedies for inadequate performance

Like all contracts, PFI agreements contain rights of termination by the government in the event of inadequate performance. But exercising such a right is not costless in either political or financial terms: litigation or arbitration is likely to ensue, due to the amount of money involved; reputation costs follow from the failure of a major political initiative for infrastructure improvement; essential infrastructure services may be disrupted, causing harm to the local population; private sector participation in other infrastructure areas within that country may be discouraged; and there are bidding costs to replace the

concessionaire after termination. Therefore service levels will have to drop to significantly below the contractual minimum before the government endures the costs of a decision to terminate. It is therefore important that PFI contracts fashion remedies short of termination – for example, adjusting payments for noncompliant performance. But in the developing world context, particular consideration must be given to the danger of such mechanisms being captured for political purposes. To minimize risks of this kind, adjustment mechanisms must be mechanical and transparent.

The same logic, that termination costs eliminate competitive incentives, applies equally in reverse for the private contractor. The termination costs for a private sector partner are often prohibitive, given the front-loaded capital and manpower investment infrastructure projects may require, and the abandonment of returns on those investments termination will likely entail. Therefore the private sector partner may be imprisoned in the contract even if it is not working out well. Consequently, the incentive for the public sector or government counterpart to cooperate to make the contract work may be reduced. This is particularly likely where the principal political value to the government agents derives from signature of the contract rather than its being performed effectively.¹¹ Therefore breaches of contract or cooperation failures by the government may be relatively prevalent.

Contract enforcement short of termination may be hampered by institutional weaknesses in domestic courts. Court procedures may be too slow. The judiciary may lack the knowledge and experience to render commercially appropriate decisions, and

may not understand the provisions of commercial contracts. Excessively technical grounds for disposal of cases, with insufficient regard to the parties' contractual intent, has been observed in developing world civil law courts: Beck et al. (2003); Merryman (1996). Judges may be susceptible to political influences, or their jurisprudence may be unpredictable or inconsistent. Procedural rules (for example about costs, appeals, remedies or enforcement of judgments) may render court proceedings of little practical utility to an aggrieved party. It is common to find severe delays in enforcement of judgments, which demotivates participation by defendants in legal proceedings, aware that enforcement of a detrimental decision can be indefinitely postponed. Unenforceable contracts become subject to constant political renegotiation and extrajudicial agreements: see e.g. Benavides et al. (1999). To an extent, problems of this ilk may be alleviated by agreements to refer disputes to international arbitration. But international arbitration is usually too slow and costly to provide for remedies in anything other than circumstances of complete contractual breakdown and cancellation, in which the parties are litigating over significant proportions of the contract price.¹² Moreover, enforcing arbitration awards generally requires complex legal proceedings to seize funds in the international banking system.

Market prediction problems and regulation

Contracts of long duration attempt to predict the future. PFI contracts generally establish modes of operation, and payment mechanisms, which make private sector remuneration a function of levels of performance. Any mechanism which attempts to do this must work

on the basis of certain assumptions about how much revenue and expenditure a given infrastructure concession will generate over the contract's lifespan. But those assumptions may be unrealistic, either because a PFI initiative has not been attempted in that sector in that country before, so there is no data on which to base the assumptions, or because a host of variables – demand levels, labour costs, energy costs, collection rates, consumers' ability to pay, transport costs, tax and duty rates – change in unanticipated ways. Because of those changes, and payment mechanisms insufficiently flexible to cope with them, it is common for PFI contracts to render private sector profits either (a) so inequitably large that they become a burden on the public purse and generate public outrage and political friction, or (b) so small as to render the private partner's interest in the venture worthless, or a burden to be unloaded. In either of these circumstances, the contract's continued performance becomes unsustainable (Riordan and Sappington 1987). In either case, there emerges a repeatedly observed cycle of the aggrieved party complaining and seeking renegotiation, and the defensive party insisting upon strict adherence to the terms of the contract that was signed. The result is often a downward spiral into the legal annals of a dispute resolution process.

It may be that no contractual payment mechanism can capture every possible change in circumstances over the course of the several year terms typical in PFI contracts. Because of this, the need for parties to have remedies short of termination for poor performance by their counterparts, and the risk of potentially abusive practices emerging from the existence of a natural monopoly, it has become commonplace to appoint an industry regulator vested with legal powers to monitor and control the

performance of the private sector participant. One typical such power is the ability to set prices, based upon the regulator's opinion of a fair rate of return given the market conditions. In this way, the regulator is intended to act as an independent umpire, arbitrating between the private sector and the government, with the authority to adjust certain features of the contract (such as performance indicators and pay scales). In order that a private sector bidder may rationally accept a regulator as part of the contractual and legal mechanism to which it signs up, he or she must have confidence in the ability and impartiality of the regulator and his or her immunity from political influences. But monopoly regulation in the developing world does not have a good track record.¹³ The independence of a regulator is hard to sustain in an environment in which the legal and institutional structures of government are relatively weak. A regulator will likely be appointed by the executive branch of government, and in practice may not possess security of tenure or budgetary control that rule-of-law ideals prescribe: Gómez-Ibáñez (2003). "Elite capture" of the regulator may occur, by either government officials or other domestic private sector interests, who then use the regulator's legal powers for ends other than efficient management of the PFI contract.¹⁴ For example, the regulator may reduce prices to help a political party achieve re-election, or restrict supply to compel consumers to switch into a competing commodity whose owners have political connections. The regulator may not be appointed on grounds of merit, and may be incompetent. An inflexible legal system may tie the regulator's hands.

In principle, the foregoing problems with PFI contracts apply as much to the developed world as the developing world. But in the developing world, these problems

may be significantly exacerbated. Because of the weak institutional structure within which government makes decisions and regulators operate, private sector contractors have the opportunity to take liberties beyond the permissible bounds of their contractual obligations. Where legal accountability is erratic, it is less likely that the parties to a PFI arrangement – government, private company, regulator, and consumers – will act in the way that the various contractual and legal regimes established to govern their relations intend. If there is no perceived risk that any party's rights will be enforced against another, a culture of institutionally unrestrained profiteering may set in. The market discipline needed to procure welfare efficiency in circumstances of natural monopoly is difficult to achieve in weak institutional environments.

IV. Collateral benefits of privatisation

Given the foregoing analysis, one might be forgiven for wondering why privatisation of public sector resources remains popular. If it is doomed to such a litany of seemingly intractable problems, can its prevalence as a tool both in development economics and in the armoury of public sector reforms in many developed world countries be explained other than as intellectual capture of public treasuries and development institutions by the international private sector? A number of reasons are developed below why one might choose to privatise notwithstanding the preceding analysis.

There are macroeconomic and accounting benefits of raising finance “off-balance sheet”. Efficiency and institutional improvements are only one side of the coin to improving infrastructure quality. The other side is increased financing. If the necessary extra money is to be borrowed by government, that will have a negative effect on a country’s balance sheet and increase its debt servicing obligations, stoking inflation. At worst, it may contribute towards deterioration in a developing world country’s credit rating, and gearing covenant defaults in other loans. By contrast, a contract with a private sector investor may yield the desired financial input to the sector without deleterious balance sheet consequences. Under a simple share-sale privatisation, the financing comes from revenues on share sales; under a more sophisticated PFI contract, it may be a term of the contract that capital investment will be made to a certain level over the lifetime of the concession, in consideration of all or part of the income from the concession’s operation. Therefore the government party to the transaction is not assuming debt.¹⁵

The international private sector has skills and experience that the domestic public sector does not, and introducing privatisation may harness these skills when they would not otherwise be available.¹⁶ The developing world often lacks the specialist technical and management skills required for successful implementation of large-scale infrastructure projects. Modern development economics emphasises capacity-building and knowledge-sharing at least as much as actual construction and operation of physical facilities. The necessary missing skills are available in the international private sector.

Politicians with responsibility for state-owned infrastructure sometimes have an agenda for its operation that pays scant regard to provision of effective services for the country's citizenry. Where political influences have captured the public sector service, or it has been rendered ineffective through managerial inertia, private participation may be an effective means of disrupting ingrained practices. Public sector employment is susceptible to bureaucratic growth as a means of arguing for and absorbing increased budget. Once management density grows beyond a certain level, managers become concerned not with the organisation's external goals, but with its internal politics. They fight with other managers for control of overlapping mandates, and to achieve political advantages over and recognition from one-another ("turf wars"). This comes at the expense of focusing their energies on pursuing the organisation's ostensible public goals, and has detrimental consequences upon the incentives of staff. They become motivated to please their managers' inefficient objectives rather than satisfy the external consumers of the organisation's outputs.

In consequence, few public sector organisations remain effective without periodic structural changes to thin down management positions.¹⁷ Achieving this is difficult, because of the vested interests of the institution's staff and managers in maintaining the *status quo*, and employees' natural resistance to attempts to break established conventions. Private sector participation can be a politically acceptable means of engineering these changes, when no palatable alternative method presents itself to the government policy-maker. Privatisation is the radical medicine that breaks inefficient path-dependence.

PFI contracts, if carefully negotiated, may contain sophisticated contractual incentives aligning the private counterpart's financial gain with efficient performance. Given a weak institutional environment, the innate welfare inefficiencies of a natural monopoly, and conditions of imperfect competition at the time of bidding, incentives for the private sector contractor to act in a way that will maximize benefits for infrastructure consumers will not exist naturally. But with careful negotiation of a contract, it may be possible for efficiency-producing incentives to be restored. These generally take the form of performance monitoring indicators ("PMIs") to which contractual payments are tied.

Creating contractual incentives of this kind is difficult. PMIs are often incomplete. Some elements of project performance are not represented in the PMIs, with the result that those elements are neglected and contractual performance is lop-sided. The solution is to discuss important project objectives in advance with the private sector contractor, and to tailor payment triggers that both sides understand and accept, and that reflect every major project goal. Often, payment triggers are too crude. The intellectual and negotiation work required to develop sophisticated PMIs may be time- and cost-consuming, but ultimately will be worth the effort to ameliorate the frictions simplistic PMIs invariably generate. Adequate tailoring of contractual incentives requires a careful understanding of (a) the engineering and management principles of the infrastructure in which the private sector party is to be invited to participate; (b) the changes in structure and incentives within the existing organisations that private sector participation is likely to entail; (c) the institutional and regulatory environment in which contractual

performance will take place; (d) the management structure and financial pressures upon the private sector; and (e) the political pressures incumbent upon the key political actors in the government departments granting the contract or concession.

The competition that exists in the PFI tender process may be used to encourage information-sharing. Successful implementation of a PFI contract requires the parties to understand in advance the institutional and financial context in which they will be operating, so that bids and contractual terms can be realistic and the parties are accordingly more likely to abide by them. This sharing of information can be encouraged by providing that bids will be evaluated in significant part by the quality of the information provided. The following examples will suffice.

It often happens that the private contractor, part way into a PFI contract, delays or reduces levels of investment previously agreed. The usual explanation for such behaviour is recalculation of profit margins, based upon new data acquired once the project is underway, that supersedes pre-contractual estimates. The new margins indicate an insufficient market return on the agreed investment, so the private sector investor seeks a way of reducing its capital contribution to make its return on investment ratios higher. Bidders should disclose the financial models on which their bids are based. If they are unrealistic, the government counterparts should note this and warn them, or assess the merits of their bids accordingly.¹⁸ Tenders should provide that the quality of financial models and data collection are a principal factor in evaluating bid quality, at least as important as price. (The onus on providing information should not lie solely with the

private counterpart; the government body should make accurate data available to the investor early in the bidding process.) Similarly, to motivate bidders to cooperate in an effort to refine PMI triggers, governments should consider stating in tenders that proposing effective triggers will be a significant feature by which bids will be evaluated.

In practice, tenders rarely state criteria of these kinds, and vital information is not shared at a sufficiently early stage to make negotiation of price, PMIs and other contractual terms sufficiently rigorous. Without concluding this information-sharing exercise, it will be mere chance whether the contract finally settled has sufficient foresight embodied within it to survive the full contract term. PFI contracts require both parties – public and private - to cooperate in ways that will render the goals and tasks of their counterpart easier to achieve. Many problems in PFI contracts arise because one party acts in a way which *prima facie* seems disruptive or perverse to the other, but which with the benefit of hindsight can be seen as a natural thing for them to do given where their interests lie. If, by means of advance disclosure of information and carefully tailored contractual incentives, the interests of private and public sectors can be more closely co-aligned, much of the seemingly aberrant behaviour observed in contemporary project finance execution might be averted.¹⁹

V. Redressing the information problem

This article has argued so far that the success of PFI contracts cannot be taken for granted, because the natural monopoly inherent in the economics of most infrastructure operations is not naturally self-regulating to achieve the most efficient result. There are a number of compelling reasons why private participation in infrastructure operation is pursued by developing world countries. But the contractual and institutional conditions within which PFI participation occurs need to be customised with some care to the particular circumstances of the country, sector, and project. This customisation will take place only where each of the parties to the contract is fully aware of the institutional constraints, financial limitations and political motivations of the other.

Private sector contractors will wish to safeguard themselves against the risk of projects on which they successfully bid subsequently running aground on the rocks of litigation or a protracted renegotiation process. They must therefore make efforts to understand the political environment within which their government counterparts operate. They must also understand the nature, and limitations, of whatever regulatory environment is in place. (In the developing world, regulation may be noticeably weaker than the developed world institutional environments in which such companies ordinarily operate.) A private sector investor in developing world infrastructure must therefore devote significant amounts of management time, and often considerable financial resources, to understand both the structure and culture of the organisation in which it is proposing to participate, and the broader economic and political issues facing the country. In circumstances of economic fragility and institutional weakness ubiquitous in the developing world, an investor must think seriously about the prospects of profitable

returns on investment being deferred considerably beyond the time periods for breaking even that standard business models predict. This is a particularly difficult message for international investors to accept. The political and economic instability of developing world countries motivates them to seek rapid returns, in case they have to withdraw unexpectedly quickly. PFI contracts cannot work effectively when the parties are labouring within this mode of thinking. Prospective investors must assess the country's longer-term prospects and stability before committing themselves, so that when an investment is made, it carries with it a degree of long-term confidence.

Likewise, government representatives bear a responsibility to inform private sector bidders about political and financial risks within their knowledge. Much of the information a bidder needs to consider the viability of a developing world project is available only from its government counterpart. In developing world countries, there is often a lack of good public statistics and economic information. The public sector must therefore approach PFI contracts in a spirit of unprecedented openness. Government may be under specific political pressures that will motivate their cooperation or lack of it, and the private sector needs to be aware of these factors in advance. Only once this information has been divulged can a fruitful discussion be had about the prospects of a PFI contract being both adequately profitable to the private sector investor, and achieving the political, economic and social goals that the government counterpart requires. It may be hard to encourage information-sharing by the public partner. Governments may not see it in their short-term interests to be open. Financiers and consultants may encourage them. Development banks have significant lobbying power, and must use it to encourage

information-sharing if they want private financing of infrastructure to be a successful component of their development strategies.

Too often there is a near-belligerent failure by each side to understand the perspective of the other. Private sector companies will not invest in any project unless they have confidence they can obtain a market rate of return on their investment within a reasonable period. Once parties to a contract, they will always seek to maximize their profits. If they cannot achieve sustainable profits, they will seek to escape the contract or subvert it. This is something government counterparts must understand if PFI contracts are to yield success. Likewise, government parties have their own array of incentives, often more complex than the relatively pure profit motive of a business. There may be competing political agendas revolving around power struggles between individuals. There may or may not be a free press and regular fair elections; either scenario places complex incentives on politicians and civil servants engaged in the political process. A regulator might be independent for a while but, with a change of political circumstances, he or she may become partisan. Private sector contractors need to understand the political context to the transaction. Only then can public and private parties agree a contractual regime likely to both maximise welfare efficiency and be observed by both sides notwithstanding institutional weaknesses in enforcement.

Information-sharing can only go so far. Some contractually relevant changes of circumstance will always be unforeseeable. Changes of government or key personnel may eviscerate the assumptions on which the contract was based. (“Key man” clauses,

requiring certain posts to be staffed by particular individuals during the course of contract execution, are usually politically unacceptable for the more important government figures.) But there is much more information-sharing that can take place than conventionally occurs now, and this can only assist success rates.

The principal conclusion so far is that the biggest problem facing successful execution of PFI contracts is inadequate pre-contractual exchange of information. There will always be perverse incentives where a natural monopoly is managed by a private corporation and the regulatory environment is weak. But these problems can be mitigated by effective exchange of information leading to the customisation of contractual terms, so parties' incentives are aligned insofar as possible. The point at which this customisation could take place, but usually fails to, is at the stage of tender, bid and negotiation of the PFI contract. It is to that stage of the project cycle, therefore, that the remainder of this paper focuses on suggestions for practical reforms.

VI. Reconsidering international public procurement

International public procurement has a tradition of being a formal, even arm's-length procedure, to ensure that all bidders are treated fairly and the award of contracts cannot be readily used as a tool for rewards based upon political favouritism. Typically, when a decision is made by the public sector bidder to offer a PFI contract, it is a one-sided process. The project structure is usually decided unilaterally by the government party.

Implementing legislation is enacted, without any input from the prospective partners who might be called upon to place a bid upon the privatisation package being assembled. A tender package is then composed, and a contract is drafted, on which bidders are invited to make offers. The winning bid is invited to sign a standard-form contract. Detailed negotiations, based upon the individualised concerns and incentives of each party, are foreclosed. In seeking to preserve the formality (and therefore the perception of fairness) of the bidding process, it is often overlooked that a PFI contract is a complicated personal relationship between two very different parties, intended to span several years and not easily terminable by either side. The terms of that relationship must be carefully negotiated if it is to last the course.

There is an irony in the international procurement process. In PFI contracts governments are seeking to capture the efficiency benefits of the private sector. But by their imposing unimaginatively rigid bidding and negotiation procedures upon their proposed private sector counterparts, they preclude the greatest potential efficiency advantage that private sector companies bring to infrastructure: an organisational structure that facilitates innovation.

The temptation within public sector environments is to follow precedents of how things have been done before, to mitigate risk of criticism: hence the desire to rely upon standard-form bidding procedures. By contrast, the private sector will have no interest in following precedent if those precedents no longer have the potential to achieve market returns: hence the cultural preference within the private sector for innovation. Where two

large private sector companies conclude a contract of high value intended to last for several years, one finds careful courting of proposed partners, an extensive process of due diligence that may take a number of months, and detailed (and often bitterly fought) negotiations of contractual documentation. Nothing is off the shelf. The process of selection, due diligence and negotiation may be painful, expensive and risky (costs are sunk if the deal does not close), but it allows each party to overcome the information problems highlighted in this article, understand the motives, incentives and limitations of the other party, fashion a detailed contract appropriate to the partner's individual circumstances, and establish a working relationship on the basis of which the partnership will proceed over the subsequent years. To the extent that this paradigm is not followed in international public procurement arrangements for PFI contracts, there is cause for concern.

The relative formality of international public procurement regimes is not all bad, particularly in countries in which relatively weak institutional constraints make the risk of corrupt or negligent procurement real. However, the counsel presented in this paper is that a balance should be struck between the formality usually associated with public sector procurement and the need to share information and negotiate contracts in detail. This is an essential process for any two partners who propose to enter into a long-term legal relationship, where each party will inevitably have its own complex array of incentives, interests and limitations upon its behaviour. Inviting fixed bids on the basis of set contracts may not encourage a culture of information-sharing.

Instead, consider extensive pre-qualification procedures, taking each individual company one at a time. For long-term contracts, it is important to remember that price is not the most important issue. Every serious bidder should be able to undertake the contract for more or less the same price, averaged out over several years and with an opportunity to recruit new staff and change management structure. An unusually low price should in many cases be cause for alarm; the suspicion will be that either the bidder intends to cut corners, or is working from naïve financial assumptions. More important qualities in a bidder include an awareness of the difficulties facing PFI contracts, detailed knowledge of the institutional and political environment in which they will be working (or an intelligently focused willingness to learn); and a credible and realistic business plan, willingly shared with its government counterpart, under which the private partner exhibits an intent to obtain a market rate of return on his investment. If the private partner's business plan is unrealistic, relations will soon sour. One point governments often find hard to grasp, frequently because of the cultural differences between public and private sector organisations, is that it is in the government's interest for the private sector partner to make a reasonable profit. If it fails to do so, it will start cutting corners or looking for an exit strategy. The idea of a seven-year "loss leader" contract worth hundreds of millions of dollars is deeply unattractive to every private sector investor, and it is naive to assume that any PFI contract can achieve development benefits where the private sector contractor is making a loss.

This approach is a significant departure from conventional contractual models, in which a contractor prices a contract at his own risk. He then takes for himself the profit to

the extent that contractual incomes exceed that price, but also takes the risk of costs overshoot and loss if the contract turns sour. The value of and investment required in PFI contracts is such that rarely if ever will a private sector party be able to run a loss leader, or continue executing a badly performing contract on the basis that the flow of new projects will balance their books. The sums involved in each individual case will be prohibitive to any such averaging exercise. Thus contractual negotiations need to foresee, and resolve, obstacles to the contract being successful for both parties throughout its term.

VII. Insights and recommendations

This paper has advanced a theoretical analysis of the difficulties facing PFI contracts where a monopoly over infrastructure assets naturally exists and conventional regulatory solutions are not available. This analysis is based upon practical experience of problems to which these contracts give rise. This paper now concludes with some recommendations to maximise the prospects of a PFI tender and project being successful, drawn from the analysis provided so far.

Standards of international public procurement should be reformed. International public procurement rules prescribe a rigid bidding procedure which leaves insufficient time and opportunities for the prospective public and private partners to engage in information sharing. Each candidate country for investment will have its own unique

institutional, legal, regulatory and cultural issues with which a private sector bidder will ultimately have to grapple if awarded the contract. But there is no way one can prepare a realistic bid without knowing these factors in advance. The usual arm's-length style of public procurement regime, under which a standard form contract is circulated and private bidders are invited to submit paper bids, does not facilitate the necessary exchange of information between the parties. Neither does it foster the necessary personal relations between key men to facilitate cooperation over the extended several year term of a PFI contract.

Because of the expense and uncertainties of litigation or international arbitration as a method of dispute resolution, novel alternative dispute resolution techniques should always be considered. It is often difficult in advance of signing a contract to engage in an open discussion about what happens if things go wrong, but it is essential for both parties to engage explicitly on the issue, given the high failure rate of PFI contracts and the expense of conventional dispute resolution methods. It may be useful to make provision for impartial experts, in the nature of international investigators or examiners, who make binding expert determinations and recommendations about the continued performance of the contract without resort to formal hearings. They may also undertake a non-binding mediation role when requested. Where disputes are almost inevitable, a dispute resolution mechanism that is relatively quick and cheap is more important than one which allows both sides a perfectly fair hearing. Such an individual may operate as a *de facto* international regulator, in lieu of a domestic regulator about whom an international private investor may be sceptical due to the risk of elite capture.²⁰ Consider agreeing the

name of such a person (and an alternative in the event of inability to perform duties) upon the contract's signature and in advance of any dispute arising. Sometimes an international organisation with an interest in the project's successful execution can act as a more or less formal mediator in the event of difficulties.²¹

In fashioning a dispute resolution mechanism, it is important to consider the preferred degree of contractual pre-emption. The common law tradition tries to make a contract exhaustive – every occurrence is anticipated in advance, and detailed provisions are made to determine the outcome in each case. This approach is not without difficulties. It is hard, faced with a contract lasting several years, to anticipate in advance everything that may go wrong. Circumstances change in unexpected ways, and legal obligations may need to change too. By contrast, the civil law tradition has developed doctrines that the boundaries of a legal obligation change with time. Contracts are much shorter, without the reams of detailed clauses typical of Anglo-American legal agreements. It is then left to the courts to develop a fair and equitable interpretation of the parties' obligations as time goes on, that fits in with whatever realities have developed.²² This model also faces challenges, particularly in the developing world. Where trust is in short supply, a flexible legal framework may motivate opportunistic demands for renegotiation. To work, it relies upon a sophisticated and independent court system with the capacity for ongoing contractual supervision, which many developing world countries may not have, or private sector investors feel they cannot rely upon. This model bears the same difficulties as do developing world regulators: politicised decision-making, lack of impartiality, and an inability to react quickly as and when necessary. So serious are these problems in the

developing world context that a cautious preference might be expressed for the common law model, but this requires a time-consuming intellectual exercise of contingency-planning, loaded up-front in the contractual preparations and negotiations.

Combining the previous two insights, some have suggested the idea of “adaptation” clauses within investment contracts, being a clause allowing the parties to renegotiate the terms of their contract if certain events take place in circumstances akin to frustration of the contract: see e.g. Berger (2003); Gotanda (2003). The test for qualifying circumstances is typically that an event occurs for which neither party is responsible and which radically changes the economic or other burdens of executing the contract. If renegotiations fail, then the parties agree that an arbitration tribunal may modify the terms of the contract to restore the “economic equilibrium” between the parties.²³ Adaptation clauses do have some advantages. A clear trigger event may be valuable if both parties foresee the likelihood of renegotiation. The threat of arbitrator-imposed contractual amendments may motivate the parties to approach the renegotiation process reasonably.

But dispute resolution clauses of this kind have not found widespread acceptance. While “renegotiation should ... be acknowledged as an integral feature of the foreign investment process” (Asante 1979, 413), compelling parties to renegotiate under threat of imposition by a third party is fraught with problems. First, at least one party (usually the party with something to lose from the process) will dispute that the renegotiation trigger has occurred. Second, the factual enquiries involved in establishing (a) what the

“economic equilibrium” is, and (b) what contractual amendments will achieve its reestablishment, is colossal, probably considerably more difficult than adjudicating an ordinary breach of contract action. Reams of economic analysis are likely necessary. Third, the delay entailed by this process may kill the contract. Fourth, giving discretion to an arbitrator to make discretionary decisions (economic equilibrium is not a legally precise test) with potentially devastating financial consequences for one or other party may be unappealing to parties engaged in pre-contractual negotiations.

Notwithstanding this paper’s scepticism about adaptation clauses, parties must be ready for the phenomenon of renegotiation during the term of the contract. Renegotiation has been prevalent within the history of international investment contracts: Kolo and Wälde (2000). Institutional capacity to make binding long-term commitments to accept foreign investment may be lacking in the developing world public sector. Therefore investment decisions must be made on the assumption that significant renegotiations are at least conceivable if political or economic circumstances change. Faced with a demand for renegotiation, it may be a less bad alternative than international arbitration. Private investors must be aware of the potentially open-ended nature of the commitment they are making when investing in long-term projects in the developing world.

PFI contracts have been common in the developing world for about fifteen years. During that time, they have been growing in sophistication and complexity. Still, they are plagued by troubles with unsettling frequency. Whether they will remain popular for another fifteen years it is too early to say. They have some real advantages. But in current

practice they are negotiated and concluded in too formal a fashion. The detailed negotiations and sharing of information required to achieve a true meeting of the minds between public and private sectors is therefore circumscribed. PFI contracts can be improved, their success rates increased. There is a cultural divide between public and private sectors that any negotiation must bridge if a PFI contract is to be successfully implemented. The private sector will always be motivated by profit and rates of return on investment. Governments must not have contempt for or be afraid of this; it is precisely the source of private sector innovation they are seeking to tap into. If it can be harnessed into an efficient set of contractual incentives, then a cautious optimism is warranted about the possibility for PFI contracts to improve infrastructure, and therefore quality of life and economic development, in the poorer countries of the world.

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¹ There are areas other than infrastructure in which privatisation, or private finance initiatives, are used. For example, publicly owned extractive industry concessions may be opened for tender to be bid upon by private companies. There are differing ways of structuring such concessions. The concessionaire may pay an up front sum and then runs the concession as an autonomous business for the period of the concession, as if it were owner, but with a commitment to return ownership over relevant hardware or infrastructure upon termination of the concession. Alternatively, the public party granting the concession may take a share in the risk and profits of the concession's operation, by way of a profit share or proportion of turnover. Many of the considerations reflected upon in this paper are relevant in whole or in part to extractive industry concessions, which can also be considered a kind of private finance initiative. But a complete analysis of extractive industry concessions is outside the scope of this paper, because of one important dissimilarity: the ultimate consumers of extractive concession outputs do have a choice (I can buy coal from mine Y if mine X sells it at too high a price), and therefore there is a competitive incentive for concessionaires to operate their concessions efficiently.

² The World Bank maintains a database of the status of international PFI projects, available at http://www.worldbank.org/privatesector/ppi/ppi_database.htm. It counts only forty-eight cancelled contracts out of 2,500 that reached financial closure in the period 1990-2001 (of which the majority were electricity distribution, telecommunications and road tolls): see Harris, Hodges, Schur and Shukla (2003).

³ The World Bank estimates that as of 2003, there was some \$86 billion of international PFI infrastructure contracts in distress, and this high distress rate is responsible for a recent trend of significant decline in the number and value of such contracts worldwide: Izaguirre (2003). Some studies have highlighted alarming distress rates in certain sectors and in certain geographic regions. Guasch, Laffont and Straub (2002) calculates that 74% of transport concessions and 55% of water concessions in Latin America were renegotiated during the 1990s.

⁴ Much of the analytical work considering individual cases has focused on Latin America. For example, see Basañes, Saavedra and Soto (1999); Benavides and Fainboim (1999); Urbiztondo (2003).

⁵ There are limits to poor service and low supply / high prices. The monopolist faces competition from alternative products / services that consumers switch to if the price is too high, and this is ultimately the limiting factor for the monopolist's price. The monopolist may have control of the only railway service from A to B, but if the tickets are too expensive then the consumer will drive or fly.

⁶ Although in principle shareholders can discipline a monopolist's conduct by compelling it to maximise its internal efficiency else they will invest their share capital elsewhere, that discipline will not generate market efficiency – only consumer discipline and shareholder discipline together can do that. Moreover shareholder discipline may not work effectively where it is very easy to make profits – “sloppiness” may take hold.

⁷ See Hayek (1980) for a critique of the notion of the idealised circumstances of “perfect competition” as a benchmark of welfare promotion. The conditions of perfect competition are too exacting: there are never an infinite number of sellers of a homogeneous product. Nonetheless, the term remains in common currency as an ideal against which a less than optimal competitive environment may be assessed.

⁸ In the developed world, another rationale for privatisation of monopolies may apply. “Bottleneck regulation” may be used to secure the benefits of private-sector competition. The government regulates activities for which the market must be dominated by only one firm, for example because the high fixed costs of building new infrastructure – such as power lines or railway tracks – discourages entry by competitors, and the costs of wasteful capital outlays to create competing infrastructure networks outweigh the efficiency gains of competition. Bottleneck regulation compels the monopoly-holder to open access to the monopoly assets to its competitors, and to do so at less than the monopoly rent. The owner of the electricity pylons must allow his competitors in the sale of electricity to consumers to use his pylons for a fee less than that the market would bear absent regulation. Effective bottleneck regulation is difficult in weak institutional environments typical of the developing world, usually because of elite capture inducing favouritism either towards the monopoly asset owner or towards a preferred supplier. Political influences make it hard for developing world domestic institutions to exercise regulatory discretion impartially. Regulation of bottlenecks is rarely used in the developing world, and even more rarely is it used to successful effect.

⁹ Demsetz (1968) acknowledges that this will defeat the benefits of Demsetz competition.

¹⁰ Theoretically, contract monitoring and enforcement, and reputation consequences of default, should resolve the problem that a winning bidder need not face competition while servicing the contract. But in practice contract monitoring is usually undertaken poorly by developing world governments due to institutional weaknesses. Enforcement is inadequate. Reputation consequences are often of limited effect, as error usually exists on both sides. Furthermore, the large sums of money involved in each individual contract render the reputation consequences in future bids comparatively insignificant relative to the losses involved in contract-compliant participation in an unprofitable project.

¹¹ One might imagine that surely the incentive for cooperation by the government party is a desire to see provision of the services anticipated. But the principal political value in such a contract may be the public relations benefit of its being signed, rather than delivery of the services in question, particularly in a developing country context in which democratic political accountability mechanisms may be imperfect. Weaknesses in political institutions may create incentives to pursue short-term political goals at the expense of longer-term policy goals. Contract signature and termination are events of sufficient magnitude that they have political as well as policy implications, and therefore are more likely to mould government conduct than is a policy desire to see improved citizen services.

¹² PriceWaterhouseCoopers (2006) cites expense and time costs as the principal disadvantages of international arbitration, “challeng[ing] one of the common myths of international arbitration, that it is less expensive than transnational litigation”.

¹³ Bakovic, Tenenbaum and Woolf (2003) enumerate instances of disputes between international investors and domestic regulators in the developing world context. Basañes, Saavedra and Soto (1999) provide a typical account of the problems encountered in attempts by Chile in the 1990s to use regulation in PFI electricity and highways projects: elite capture, failure to exercise legal powers, incomplete powers and enforcement problems. Benavides and Fainboim (1999) argue that regulation in the fields of electricity and mobile telephony in Colombia had some limited successes in the 1990s. But accounts of such success stories in the literature are relatively rare. They accept that elite capture, excess numbers of different regulatory bodies, and a shortage of technical skills within the regulatory institutions presented real problems for effective regulation.

¹⁴ Even in developing world countries with relatively strong institutions and a reasonably thorough rule of law tradition, securing sufficient independence and strength in the regulator, and maintaining a rapid and complete regulatory response, is a challenge: see Basañes, Saavedra and Soto (1999) for the example of Chile.

¹⁵ Opinions about the circumstances in which a project contract need not appear on a government's balance sheet vary. Many public and private sector lenders use risk ownership as the litmus test of whether a project should be considered to be off balance sheet. For example, if capital risks (e.g. a hospital burning down) and income / profit risks (e.g. water rates not generating sufficient revenue to cover set-up and operation costs) are taken by the private sector party under the contract's terms, then the project may be treated as off balance sheet for accounting purposes. However, even in such cases, there remains a powerful argument that the project should appear on the government's balance sheet to the extent that the government undertakes any obligation to make regular payments, for example an annual service charge, which may include a deemed financing charge. Where there is any regular obligation by government to pay unlinked to revenues created by the project, the project is acting as a burden on the public purse in much the same way as a loan repayment. In Australia, every PFI contract is included on the government's balance sheet; the rationale is that any contrary treatment is just an accounting fiction. For a survey of the debate about the considerations properly relevant to the accounting treatment of project contracts between public and private sectors, see Eurostat (2004); also UK Accounting Standards, Application Note F to FRS 5, at <http://www.frc.org.uk/asb/technical/standards/pub0100.html>.

¹⁶ This benefit is related to the efficiency advantages of the private sector. The private sector retains people with specialised skills, and pays them market rates for these skills, because the threat of competition motivates a desire to invest in human capital. Public sector organisations do not face that threat and so are not motivated to invest in human capital to the same degree. Developing world countries, with weak policy-making capacities, are particularly liable not to so invest.

¹⁷ Many private sector organisations suffer from the same phenomenon, notwithstanding the theoretical existence of competitive incentives to prevent it. For private sector organisations, this "fat" usually develops during periods of easy profit, and is noticed only upon economic downturn or other profit-threatening market change.

¹⁸ Bidders may have an incentive to understate their bids, because they are confident they can have the price adjusted upwards subsequently as part of a renegotiation process, should the financial assumptions upon which their bid is premised appear inaccurate. To prevent this, the public sector counterpart needs to put significant resources into estimating costs of service provision, and to assess bids using those estimates. However, there is a danger in the public sector counterpart undertaking this role: bidders may not have an incentive to provide full (or any) information, for fear that it will be used against them. One possible way of breaking this perverse incentive might be to place bidders in competition with one-another to provide the best data to the government, by providing that one of the principal criteria by which bids will be evaluated is the quality of information provided.

¹⁹ Review of an early draft of this paper elicited the following criticism of this point. If it is argued that institutional weaknesses prevent effective contractual monitoring, then how can effective collection, processing and sharing of information, and consequent tailoring of contractual terms, be useful, because the

tailored terms cannot be monitored and therefore cannot be enforced. There are two responses to this. First, information-sharing makes it more likely that effective contract-monitoring takes place, because the parties develop an appreciation for what might go wrong and what needs to be given attention in order that execution by both sides is effective. Second, careful crafting of incentives will make vigorous contract-monitoring less important: the parties will be motivated to observe the contract without the threat of monitoring and enforcement by the counterpart. When working in weak institutional environments, therefore, a particularly straightforward, self-enforcing type of contract is particularly important.

²⁰ Bakovic, Tenenbaum and Woolf (2003) advocate a regime for international appeals from domestic regulators, being quicker and less formal than full international arbitration of regulatory issues.

²¹ MIGA seems to have undertaken this role with a reasonable degree of success in several cases: see Weisenfeld (2004).

²² The distinction between the two legal traditions towards contractual preemption is explored in Kolo and Wälde (2000).

²³ There are a number of model adaptation clauses found within model agreements. The “Qatar clause” is one such clause. The 1994 model exploration and production sharing agreement of the Sheikdom of Qatar states that “if any future law, decree or regulation affects Contractor’s financial position, and in particular if the customs duties exceed ... percent during the term of the Agreement, both Parties shall enter into negotiations, in good faith, in order to reach an equitable solution that maintains the economic equilibrium of this Agreement. Failing to reach agreement on such equitable solution, the matter may be referred by either Party to arbitration ...”.