WORKSHOP ON THE AWARD OF CONCESSION CONTRACTS

An Economist's View on Concessions

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Starting Point: What are Concession Contracts?

- **Main characteristics of concessions are:**
  - Transactions that usually involve important investments
  - Risk transfer (Especially the risk of demand)
  - High level of uncertainty
  - Long-term agreements
    - (e.g. Millau Viaduc, 78 years long contracts)

- **Incomplete contracts** (Williamson 1985)

- Concession contracts are clearly specific compared to public contracts!

What kind of problems do they generate?
What are the Problems Associated With The Award of Concession Contracts? (1)

• The natural way to award a concession contract is through call for tenders in order to foster competition.

• One question: rigid or flexible rules of the game?

• The recent economic literature suggests that call for tenders with rigid rules perform poorly when projects are complex, contractual design is incomplete and there are few available bidders on the market (Bajari-McMillan-Tadelis 2009)

• WHY?
What are the Problems Associated With The Award of Concession Contracts? (2)

• Main problems identified by the economic literature:
  
  • **Low-balling strategy**: offers containing promises difficult to meet, for the sole purpose of winning the contract
  • **Winner’s curse**: optimistic bidding
  • **Renegotiation issues**
  • Collusive agreements
  • Favouritism and corruption
What are the Problems Associated With The Award of Concession Contracts? (3)

- **Renegotiations are the rule, not the exception**
  - 1000 concession contracts signed in Latin America between 1980 and 2000 – more than 40% are renegotiated less than 2 years after their signature on average (Guasch [2004]).
  - Renegotiation rate of 121 PFI contracts signed before 2000 in the UK has been estimated at 55% (NAO [2001]) but the House of Commons (2011) pointed out the fact that one drawback of English PFIs is their rigidity.
  - A recent study on Car Park concessions in France found out that the frequency of renegotiation is once every two years on average and seem to be profitable to consumers (De Brux & al 2011).
  - Engel, Fisher, et Galetovic (2011) found concerning transport concessions signed since 1991 in the United States that “six out of twenty projects have undergone a major change in the initial contractual agreement, favouring the concessionaire, and two additional projects have pending renegotiations” ((2011), page 11).
  - …
What are the Problems Associated With The Award of Concession Contracts? (4)

- **What to think about renegotiations?**
- Renegotiation can be justified as soon as you need to adapt the contract to unanticipated events.
- They can also reflect opportunism and/or corruption.
- They can arise because of too flexible contracts
- They can arise because of too rigid contracts
- **They arise because contracts are imperfect** (i.e. incomplete)
What are Potential Solutions?

What the theory suggests is that:

- A (limited) discretionary power of the buyer (at the selection stage) is necessary!
- Reputation of bidders should enter into criteria!
  - Select the one you know you will be able to (re)negotiate with because you will renegotiate for sure! This is a long term partnership...
  - Some empirical studies confirm this proposition: Pacini and Spagnolo [2011], Bajari-McMillan-Tadelis 2009

But then how to avoid favoritism and bad renegotiations?
What are Potential Solutions?

• How to avoid favoritism and bad renegotiations?
  • Find the right level of transparency without favoring collusion strategies!
  • Given their potential negative effects on governance and efficiency, renegotiations should be extremely open and transparent procedures!
    • To improve on transparency, the contract may envisage calling a third party, e.g. an arbitrator, an independent commission, or a group of experts, to evaluate the case and seek to conciliate the needs of both parties without too much harm for the consumers
  • Find contractual solutions!
    • Anticipate ex ante how you will renegotiate ex post
    • New kinds of contractual agreements are to be found and start emerging
    • Contract duration and LPVR
What are Potential Solutions?

- Contract duration: the LPVR solution
Implications For the New Directive

• Do we need a directive? Yes
• Do we need a specific directive? Yes
• What kind of directive?
  • A light one
    • There is no point establishing rigid rules for award procedures: this would not assure fair competition between competitors and this would not favour efficiency of concession contracts because actors anticipate that such contracts are generally renegotiated ex post
    • Rigidifying renegotiations ex post is not a solution. It would stick partner in bad deals as soon as contracts are misaligned with their environment + risk premium.
  • A light directive, coupled with more transparency is needed to permit flexibility without strategic behaviours from economic actors.
References


To know more...


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This conference focuses on the recent developments in contract theories. Papers are invited on all topics of contract theories including: Relational contracting, transaction costs, renegotiations, incentives, attribution mechanisms, incomplete contracting, contract design, benchmarking, privatization, corruption, institutions.

Papers presented may be theoretical or applied. A special attention will be given to proposals addressing issues related to procurement and public-private arrangements. The conference will bring together academics, policymakers and practitioners to discuss those issues. The conference format will be designed to facilitate informal interactions among participants and promote future collaborations.

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