



(Research Article)

The Renegotiation Trap: Political Economy Factors Driving Opportunistic Contract Modifications in Public-Private Partnerships

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ABSTRACT

Public-Private Partnerships (PPPs), as an instrument of global infrastructure governance, have created a widespread issue among governments: the widespread renegotiation of PPP contracts. Renegotiations occur at a rate far greater than would be expected under normal circumstances; therefore, it can reasonably be concluded that most PPP renegotiations are opportunistic. This article examines why the renegotiation of PPPs occurs so frequently. The authors call this problem the “Renegotiation Trap,” because there exists a self-reinforcing cycle of political incentives, opportunistic bids, contract incompleteness, and lack of institutional oversight that makes renegotiating PPP contracts both possible and strategically rational. The authors draw upon three bodies of literature to explain why renegotiating PPPs occurs. First, incomplete contract theory is utilized to understand why renegotiating PPPs is necessary. Second, political economy frameworks are used to understand who benefits from the renegotiation of PPPs. Third, data collected from over 1,000 Latin American concession agreements are analyzed to identify when and how renegotiations occurred. Using these three approaches, the authors found that the primary causes of renegotiating PPPs were: (i) election cycles; (ii) soft budget constraints; (iii) bidder’s curse; (iv) information asymmetry; and (v) corruption. The authors also evaluate different reform options to improve the renegotiation process. These reform options include creating an independent regulatory body to oversee the renegotiation process, holding open auctions to determine the best price for services, requiring public disclosure of renegotiated terms, and providing additional funding sources for renegotiation. The authors conclude that improving the renegotiation process requires changing the political structure that provides the incentives for renegotiating PPP contracts rather than just changing the language contained within those contracts.

Keywords: *public-private partnerships; contract renegotiation; political economy; incomplete contracts; opportunistic behavior; infrastructure governance; concession contracts*

I. INTRODUCTION

Public-private partnerships (PPPs) have become a leading way that governments throughout the world finance and deliver new infrastructure. A PPP has a private company designing, financing, building and operating an asset (a highway, a hospital, a water treatment facility, etc.) for an agreed-upon number of years. At the end of that term, the public agency takes back control. In theory, PPPs provide private efficiencies while transferring risks off the public books, and providing incentives for high-quality performance. However, empirically the results are disturbing.

The most obvious example of how poorly PPPs perform is through renegotiation. Guasch (2004) did research on approximately 1,000 concession contracts issued to private companies in Latin America between 1985 and 2000. He discovered that about 30 percent of the concessions he reviewed were renegotiated. He also discovered that in the case of concessions related to roads and highways, over 50 percent of the concessions were renegotiated. Perhaps just as important, Guasch (2004) noted that the average amount of time it took before there was renegotiation was only two and one-half years from when the contract was signed, and that over sixty percent of all concessions were negotiated prior to the third year of operations. These numbers do not reflect typical

adjustments to changes outside the control of either party; instead these numbers indicate a systemic problem — a renegotiation trap.

A renegotiation trap refers to a situation where concessionaires deliberately bid low when they obtain a contract because they know that eventually, due to sunk investment and potential political ramifications of breaking a contract, the government will be willing to negotiate and modify the terms of the agreement to make them better for the concessionaire. Similarly, public officials who approve such agreements may view renegotiation as an opportunity to increase public expenditure without increasing their current budget. As a consequence, a contracting regime emerges in which the discipline inherent in the competitive bidding process is destroyed, additional costs are passed to future generations or taxpayers, and the original public interest justification for PPPs is continually undermined.

This article presents a thorough political economic examination of the renegotiation trap. Section 2 presents a summary of the theoretical framework based on incomplete contracting theory. Section 3 discusses the demand side of politics — why government officials would want to renegotiate a concession contract. Section 4 explores the supply side — why concessionaires would engage in underbidding strategies. Section 5 outlines the institutional/structural weaknesses which allow concessionaires and/or government officials to engage in opportunistic renegotiation. Section 6 provides examples of various studies examining the renegotiation trap across multiple regions including Latin America, Europe and North America. Section 7 assesses several proposals designed to reform institutions in order to prevent the renegotiation trap. Section 8 summarizes the findings of this paper.

II. THEORETICAL FOUNDATIONS: INCOMPLETE CONTRACTS AND HOLD-UP

Any study of PPP renegotiation should be based on the theory of incomplete contracts. Incomplete Contracts Theory by Hart and Moore (1988) identified an important principle that any long-term contract will be incomplete. Because there are too many potential future events that can occur, it is impossible to include them in a written contract. Consequently, there will always be gaps between the language of a written contract and the actual working conditions at the time of performance. When considering the long duration of PPP contracts (i.e., 20–40 years), the sensitivity of the services provided to both technology changes and fluctuations in demand, along with the multi-dimensional nature of service specifications which are difficult to write into a contract (Iossa & Martimort, 2015), the incompleteness of PPP contracts is inherent and not merely accidental.

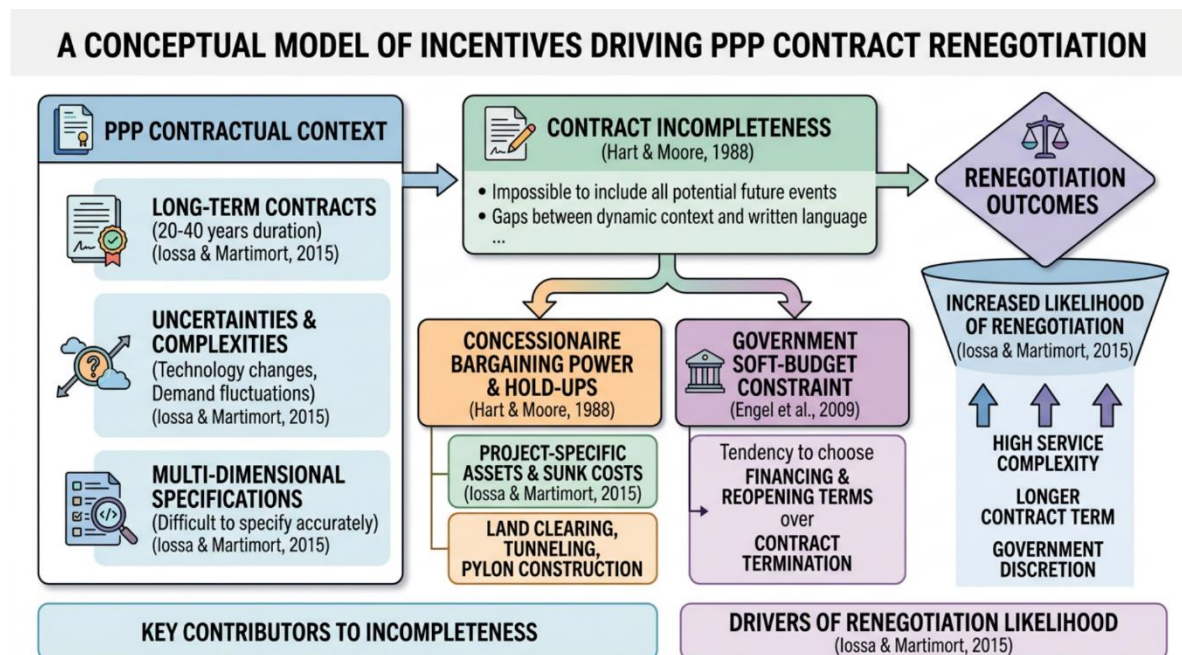


Figure 1. A Conceptual Model of Incentives Driving PPP Contract Renegotiation.



As described by Iossa and Martimort (2015), once a concessionaire invests in “project-specific” assets such as land clearing, tunneling, and pylon construction, these investments become sunk costs. As a result, the government cannot threaten to remove the concessionaire from their contract without incurring large amounts of additional costs and inconvenience; including the loss of public support due to disruptions in service. As a result, the concessionaires have considerable bargaining power after they have made these investments, thereby providing the opportunity for hold-ups (Hart & Moore, 1988).

Engel et al. (2009) developed a complementary perspective using the soft-budget constraint literature. They used this perspective to demonstrate that governments systematically act as soft-budget actors when dealing with PPP concessions. Even if a concessionaire fails to meet its contractual commitments, the government will typically find it preferable to either provide further financing or negotiate new terms rather than terminating the contract. Iossa and Martimort (2015) formally demonstrated how the incentives created by PPP contracts lead to certain informational asymmetries that systematically favor concessionaires in renegotiations. According to their model, the likelihood of renegotiation increases as a function of: (1) the level of complexity of the service being contracted; (2) the longer the term of the contract; and (3) the degree of discretion possessed by the contracting authority.

III. DEMAND-SIDE POLITICAL DRIVERS: WHY GOVERNMENTS SEEK RENEGOTIATION

A. Electoral Incentives and Fiscal Manipulation

While traditional analysis focuses on how private sector parties exploit the renegotiation process, a key characteristic of the renegotiation trap is that governments are not merely victims of the renegotiation process but rather often lead it. Guasch et al. (2007) used a database of concession contracts from Latin America to demonstrate that a large percentage of renegotiations initiated by governments are politically driven and not operationally driven. One of the primary drivers of public demand for renegotiation is the electoral cycle. As an election approaches, incumbent governments are motivated to increase expenditures on visible public services — additional highway lanes, new hospital wings, etc. — to gain immediate short-term voter popularity. Renegotiation of PPP contracts provides an attractive means of meeting these goals: by negotiating a modification to the concession agreement that will allow for funding of additional works, the government can increase total infrastructure spending without formally recording new debt on the public books.

Engel et al. (2009) developed a theoretical model demonstrating that, under reasonable assumptions regarding accounting practices, renegotiation-financed spending is economically advantageous to incumbent governments since the cost of such spending is incurred by future administrations rather than by current voters. Guasch et al. (2007) presented direct empirical support for this theory, showing that the occurrence of national elections during a particular year has a positive effect on the likelihood that a government will initiate a renegotiation. Therefore, from a political economy perspective, renegotiation constitutes a form of inter-temporal fiscal manipulation — a means whereby governments may circumvent fiscal constraints while remaining electorally viable.

B. Planning Failure and Corruption

Another major demand-side driver of renegotiation involves the “planning failure” problem. Contracting authorities frequently award contracts based on demand forecasting and cost estimating information that is known ex ante to be overly optimistic. Flyvbjerg et al. (2002) demonstrated that cost underestimations for transportation projects are systematic and widespread, and most likely due to strategic misrepresentations rather than innocently erroneous forecasting. When optimistic forecasting fails to bear out, the contracting authority typically must decide whether to publicly acknowledge the “planning failure” or quietly pursue a renegotiation of the contract. From a purely political perspective, the latter option is clearly preferable, as publicly acknowledging planning failures creates opportunities for legislative oversight, audit reviews and potential electoral accountability.

Corruption also contributes to a more complex view of the demand-side factors. Guasch and Straub (2009) established strong empirical evidence indicating that greater levels of corruption within Latin American transport and water sectors positively correlated with higher frequencies of concession contract renegotiations. The mechanism behind this correlation is not limited to overt forms of bribery; subtler mechanisms exist including revolving door relationships between regulatory bodies and concession operators, creating patterns of regulatory capture where contracting authority personnel who oversee contract compliance have personal career interests in accommodating concession operator demands for contract modifications.



IV. SUPPLY-SIDE DYNAMICS: STRATEGIC CONCESSIONAIRE BEHAVIOR

A. Opportunistic Bidding and the Soft Budget Equilibrium

On the supply-side, the renegotiation trap is maintained by rational and anticipated actions by concessionaires. It is based primarily upon aggressive or opportunistic bids submitted strategically at less than the actual cost of completing a project, or greater than the real demand for the concession services, anticipating subsequent renegotiations on better terms. Guasch (2004) noted that such behavior (often termed “lowballing” in procurement literature) occurs regularly throughout concessions in Latin America. Due to the fact that renegotiation can occur only after the final bidding process has completed and other bidders have lost their opportunities to bid, the concessionaire goes from a competitive market to a bilateral monopoly.

Engel et al. (2009) introduced an economic equilibrium to capture this behavior through their soft budget model. The model demonstrated that, in an anticipated renegotiation environment where competition drives down initial bids in exchange for future gains from renegotiation, the level of competitiveness would drive the size of those gains. The equilibrium was shown to be self-reinforcing; as renegotiation becomes more anticipated, the aggressiveness of bids increases, which increases the fiscal pressures to renegotiate, validating the original anticipation. Importantly, the equilibrium is not simply a second-best result — it is welfare-destroying because it turns what should have been a competitive procurement process into a mechanism for extracting a bilateral monopoly rent at the taxpayers’ expense.

B. Winner’s Curse and Information Asymmetry

PPP auctions also provide another potential mechanism to explain renegotiation. In these types of auctions, concessionaires who have overly optimistic expectations about demand and/or very low cost projections tend to win the contract; however, upon taking possession of the project, find out that their winning bid price estimate was based on unrealistic assumptions. Athias and Nuñez (2009) found that there is an increase in the probability of renegotiating the contract as the number of bidders in the initial auction increases, supporting theory that greater competition in an auction produces a winner with a greater “winner’s curse” than less competitive auctions. Casady and Baxter (2020) expanded this research on U.S. PPP projects and found evidence of winner’s curse type behaviors for many high-profile renegotiations such as the Indiana Toll Road and the Chicago Skyway.

Information asymmetry between private concessionaire and government contracting authority represents yet another source of leverage to affect renegotiation from the supplier side. As private concessionaires run and maintain large-scale infrastructure operations over time, they collect and develop considerable amounts of detailed operational data related to costs, traffic, maintenance needs etc., that typically cannot be observed or evaluated by the government authority. Cruz and Marques (2013) provided empirical support for this type of strategic misrepresentation in Portugal road concession renegotiations. They found that traffic volume being below forecasted levels was the single largest reason for renegotiation; however, in nearly one-half of all renegotiations investigated, the traffic forecasting used as basis for claiming underperformance was conducted by the concessionaire itself.

V. INSTITUTIONAL AND REGULATORY WEAKNESSES

Although renegotiation of PPPs cannot be solely attributed to the actions of individual entities, an institutional context that allows for or encourages opportunism of renegotiation is also necessary. A number of structural characteristics of PPP governance systems identified through the literature provide consistent examples of “enabling” conditions of renegotiation.

Firstly, contractual incompleteness at the time of design provides a basic prerequisite for renegotiation. Athias and Saussier (2010) found that the degree of rigidity of the initial contract (measured by the presence of dispute resolution mechanisms, performance criteria, and trigger points for adjustments) had a significant effect on the likelihood of renegotiation occurring subsequently. However, excessive contractual rigidity may have similar negative consequences, restricting welfare-enhancing adaptation to genuine changes in circumstances. Thus the problem for contract designers is to achieve sufficient contingency to allow for such adaptation, while avoiding creating renegotiation opportunities.

Secondly, regulatory independence represents a further key institutional factor. Guasch et al. (2003) found that the existence of a sector-specific independent regulatory body had a statistically significant effect on reducing the likelihood of renegotiation in PPPs within Latin America. An independent regulator with technical expertise and



protected from political interference through statute is better placed to resist both types of renegotiation initiated by either side. Conversely, in the absence of regulatory independence, the contracting authority acts as both party responsible for enforcing the contract and the party most likely to gain from renegotiation — clearly a conflicting interest.

Thirdly, fiscal accounting rules represent yet another form of enabling condition. Until relatively recently, standard government accounting practices allowed for PPP renegotiations to be treated as “off-balance-sheet,” thus treating the additional payments made to concessionaires as operational spending rather than as public investment. Maskin and Tirole (2008) provide theoretical evidence demonstrating that when combined with fiscal rule frameworks that penalise explicit public debt but not implicit PPP liability obligations, these rules create systemic incentives for governments to use both the original PPP arrangement, and subsequent renegotiations, as mechanisms for evading their own expenditure limits.

VI. EMPIRICAL EVIDENCE ACROSS REGIONS AND SECTORS

A. Latin America

Much of the evidence comes from Latin America where the largest empirical base is a database compiled by Guasch (2004). This database covers almost 1,000 concessions in communications, electricity, water, and transport. A number of studies have demonstrated that the average renegotiation rate for these concessions exceeds 30 percent overall and 54.4 percent in transport. The majority of renegotiations favored the concessionaire: Guasch (2004) estimated that about two thirds of renegotiations resulted in tariffs being increased; that 38 percent of renegotiations resulted in an extension of the term of the concession agreement; and that two thirds of renegotiations resulted in a reduction of investment obligations on behalf of the concessionaire.

Chile is particularly interesting to analyze as it offers a great deal of detail regarding its experience with PPPs. Several studies demonstrate that a very large portion of Chile’s PPP highway concessions granted by the Ministry of Public Works from 1992 to 2005 were renegotiated by 2006. Further, studies show that about one fourth of all public funds invested in infrastructure over this period were provided through renegotiation rather than through the competitive bid process originally established to finance the projects.

B. Europe and North America

Cruz and Marques (2013) studied road concessions in Portugal and concluded that renegotiations were caused primarily by less traffic than anticipated — supporting the hypothesis related to aggressive bidding. Similar trends were observed in France and Spain by Saussier et al. (2009), who further stated that renegotiation was more common in countries with poor quality regulations and institutions. Casady and Baxter (2020) completed the first systematic survey of U.S. PPP renegotiations involving transportation and social infrastructure. Their findings indicate that U.S. PPPs are not exempt from opportunistic renegotiation, and several well-known examples, including the Indiana Toll Road Bankruptcy and several toll road concessions in Texas, exhibit similar characteristics of aggressive initial bidding leading to financial difficulty and contract modifications.

VII. REFORM PATHWAYS: BREAKING THE RENEGOTIATION TRAP

A. Independent Regulatory Oversight

One of the best-known reforms relates to increasing the independence of regulators. If electoral incentives lead to government-led renegotiation, then institutional remedies include placing contract oversight under the responsibility of an independent regulator whose activities are not influenced by these electoral incentives. Statutory independence, technical competence, and procedural accountability are the criteria used to evaluate the quality of regulatory capacity. Guasch et al. (2003) showed that simply having a sector-specific regulator had a significant effect on the reduction of the renegotiation probability. Subsequent research has emphasized that the effectiveness of a regulator depends more on its capacity than merely on its presence.

B. Competitive Renegotiation and Fiscal Transparency

Another reform refers to the use of competitive procedures for renegotiating contracts. In cases where there is no other solution but to renegotiate, Engel et al. (2009) suggest that such negotiations be carried out competitively, allowing alternative operators to submit offers for the renegotiated contract. This reform directly deals with the hold-up problem, since concessionaires know that a new competitive tendering procedure will be triggered



whenever they attempt to negotiate. While this reform may raise some difficulties in practice given the high transaction costs related to re-tendering an infrastructure asset that is partially built or operating, the empirical evidence indicates that credible threats of re-tendering, although rarely exercised, significantly constrain concessionaire behavior.

Finally, another area of reform relates to increasing transparency regarding fiscal transactions. According to Maskin and Tirole (2008), governments opt for PPPs in part as a means of financing public services outside of fiscal deficit rules. Reforming public sector accounting standards so as to require consolidation of PPP liabilities on the government's balance sheet — as has been done progressively by Eurostat pursuant to revisions to the European System of Accounts — diminishes the off-balance-sheet advantage associated with using renegotiation-financed expenditures. Although this reform does not eliminate the underlying political incentives leading to renegotiation, it makes visible to politicians and citizens alike the fiscal consequences of such action.

VIII. CONCLUSION

This paper has demonstrated that contract renegotiation as part of opportunistic contract modifications in PPPs does not represent an anomaly. Instead it represents a logical consequence of a political economy structure within which (1) governments have an electoral interest in expanding spending “off budget”; (2) concession companies have bidding incentives to reduce their prices for contracts with a view to being able to renegotiate them at a later date; (3) regulatory bodies are unable to resist the pressures of such actions due to a lack of independence and capacity; and (4) fiscal accounting rules create lower political costs for government spending financed through renegotiations than those arising from publicly funded spending. The convergence of these four elements gives rise to the renegotiation trap — a self-sustaining cycle where the formal competitive process inherent in the procurement of PPP contracts is consistently undermined by an expectation common to both parties that the original contract was never intended to be the final version.

The empirical record clearly shows that: (a) renegotiation rates are very high for all three regions mentioned (Latin America, Europe, and North America); (b) renegotiations tend to favor the private contractor; and (c) renegotiations occur predominantly during the first few years after the granting of the concession. These results are consistent with both the political economy theory and the strategic bidding theory discussed throughout this paper. These findings suggest serious negative welfare implications: renegotiated costs are borne by taxpayers and/or future generations; PPP procurement is expected to generate competitive efficiencies which are lost when renegotiation occurs; and public confidence in the management of infrastructure is negatively affected.

To address these issues effectively and escape the renegotiation trap requires intervention into the political incentive structure underlying PPP projects. Contract language changes will be insufficient. Rather, independent regulatory agencies need to be established, competitive renegotiation processes implemented, fiscal transparency mechanisms need to be developed that prevent the use of PPP spending as off-balance-sheet financing, and there needs to be significant investment in developing public contracting capabilities. All of these reforms will impose significant political costs — they will each constrain the discretionary power of elected officials and challenge the financial interests of established concession contractors. However, without addressing these structural institutional constraints, the renegotiation trap will continue to dominate PPP project governance.

Finally, the authors anticipate that future research will pursue two fronts. First, comparative institutional studies regarding how best to regulate PPPs need to include a systematic examination of the effectiveness of different regulatory architectures, particularly with respect to independence, capability and accountability across various political economies. Secondly, preliminary empirical evidence exists regarding digital infrastructure PPPs and health sector concessions, raising interesting questions concerning whether the patterns identified in transport and utility sectors can be extrapolated to these newer institutional contexts.

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