Prof. Predrag N. Cvetković, LL.D.
Associate Professor,
Faculty of Law, University of Niš,
pepicvetkovic@gmail.com

OPPORTUNISM OF PRIVATE ACTORS IN PUBLIC-PRIVATE PARTNERSHIPS

* University of Niš, Faculty of Law, pepicvetkovic@gmail.com.

A researcher on the project "Human and Minority Rights' Protection in the European Legal Space" (179046) which is carried out at the Faculty of Law, University of Niš, and financially supported by the Ministry of Education, Science and Technological Development of the Republic of Serbia.

A researcher on the project "Sustainability of the Identity of Serbs and National Minorities in the Border Municipalities of Eastern and South-eastern Serbia" (179013), which is carried out at the Faculty of Mechanical Engineering, University of Niš, and financially supported by the Ministry of Education, Science and Technological Development of the Republic of Serbia.

This paper is the result of the research on the project "Harmonizing the Serbian Legislation with the EU Law", which is financially supported by the Faculty of Law, University of Niš, in the period from 2013 to 2018.

The Author's Academic Biography

Predrag Cvetković (born in Niš on 15th February 1970) is an Associate Professor who teaches International Trade Law at the Faculty of Law, University of Niš. He is the author of three monographs and over 70 scientific and expert papers. The subject of his interest is the Law of the World Trade Organisation, the legal regime of foreign investments and International Commercial Law. He has published a number of papers dealing with public-private partnerships, such as: "Public-Private Partnership as the "HORIZON 2020" Implementation Tool: The Main Methodological Issues (pp. 101-110), the Centre for South-East European Law School Network, Skopje, 2014; and "The Legal Regime of Public-private Partnerships as a Form of "Hybrid Regulation" (Collection of Papers, Faculty of Law, Niš, 2014).

OPPORTUNISM OF PRIVATE ACTORS IN PUBLIC-PRIVATE PARTNERSHIPS

Abstract

The paper deals with the issue of opportunism of private actors in Public-Private Partnerships (PPP). The problem of opportunism in the implementation of a PPP project stems from the fact that the parties' relations are strained by the tension stemming from their conflicting interests. The organizational structure and the *modus operandi* of a public actor are aimed at accomplishing and promoting a general (public) interest. The aim of a private actor is to make a profit. This paper analyzes the reasons for the opportunism of a private actor in a public-private partnership, with emphasis on the "hold-up" problem imposed on the public actor. In particular, the hold-up problem is reflected in the fact that a public actor has to agree with the changes proposed in the PPP agreement by a private partner. This agreement is based on the fact that a public partner has no actual opportunity to protect the "initial agreement" contained in the original contract. The author proposes that the problem of opportunism shall be resolved *ex ante* by introducing relevant clauses in the PPP agreement. These clauses shall oblige the private partner to pay the price for their opportunistic behaviour. Therefore, the proposed methodology has a pre-emptive effect on the possible opportunism of a private actor.

Keywords: public-private partnership, opportunism, "hold up" problem, project-specific investments.

INTRODUCTION

Public-Private Partnership (hereinafter: PPP) is a framework for resolving the tension between the public and the private sector, primarily for the purpose of raising the quality of establishing, accomplishing, protecting and developing the public interest (Cvetković & Milenković-Kerković, 2011, 758-759). This tension is generated by the conflicting nature of the basic characteristics of these two sectors. The organizational structure and the *modus operandi* of the public sector are aimed at protecting, accomplishing and developing the general (public) interest. The private sector is based on private initiative, primarily aimed at making a profit. This distinction is the key factor in understanding the structure and the implementation of a public-private partnership.[1]

Opportunism of PPP Actors

The problem of opportunism in the implementation of PPP projects stems from a general attitude that the actors of a public-private partnership feature the elements of "*bounded rationality*": the boundaries of their rationality are defined by their interests.

The rationality of a public partner is based on the achievement of political goals. In transition countries, this rationality seldom lasts longer than an election period, which is inconsistent with the prospects of considering the rights, duties and responsibilities of the PPP project parties in a period of several years or even decades[2].

The rationality of a private partner is governed and restricted by the market-oriented action model, which generally does not make allowances for the public interest whose exercise is a constituent part of a public-private partnership.

The potential for opportunism is largely determined by the interest-based rationality of the PPP actors. The opportunism of parties involved in a public-private partnership is reflected in

[1] In Serbian legislation, the subject matter of public-private partnerships is regulated by the Public-Private Partnership and Concessions Act (Official Gazette of the Republic of Serbia, No. 88/2011). Public-private partnership is one of the three methods of putting infrastructure project into effect and exercising the public interest activities. The other two are: the implementation of these projects by using private financial, personal and other resources (the so-called "in house" method), and financing these projects by means of loan capital. As compared to the other two methods, the PPP profitability is estimated by comparing the values obtained by applying each of the three methods on a specific project. The Commission for Public-Private Partnership and Concessions of the Republic of Serbia adopted a document called "Methodology for the Earned Value Analysis in Relation to the Invested Funds ("*Value for Money*") in Public-Private Partnerships and Concessions." This document concisely defines the notion of the "value for money" methodology (paragraph 3, page 1): "The assessment of the earned value in relation to the invested funds (determining "*Value for Money*", VfM) refers to the application of an analytical procedure involving the use of quantitative tools in order to determine whether tax payers would have more benefits from the application of the traditional investment model, where a public entity acts as the investor assuming all or a substantial part of the public investment risk, or whether it would be more beneficial to use the services of bidders from the private sector, thus transferring (allocating) most of the risk involved in a public-private partnership relations onto them. Therefore, the idea of maximising the earned value for public funds is based on the transfer of certain public investment risks onto the private partner. The public sector acts as a procurement agent whose goal is to provide some public service to the end-user, whereas the private sector acts as a contractor who provides the agreed services stipulated in the contract." This methodology is available at the Commission website: http://www.ppp.gov.rs. For more information on the application of the PPP concept in specific fields, see: Lepotić-Kovačević, 2012.

[2] The Serbian Public-Private Partnership and Concessions Act prescribes that a PPP agreement may be contracted for a period of at least 5 years and that it shall not exceed a period of 50 years. See: Article 18, par. 2 of this Act.

a tendency of one party (either the public or the private entity selfishly pursuing its own interests) to oblige the other party to act in a manner which is contrary to the governing PPP principles *in concreto* stipulated in the PPP agreement.

The opportunistic behaviour of a private actor is illustrated in the following example. Upon entering into an agreement with a public partner, a private partner assumed the obligation to carry out a project concerning the construction and exploitation of a waste processing facility. The project was to be realised in two stages: the construction stage and the exploitation stage. Although the contract covered a period of ten years, the private partner intended to terminate the contract after five years (which was the due date for finishing the construction stage and beginning the exploitation stage). Thus, after finishing the construction stage and collecting the payment for construction works, the private partner decided to terminate the contract before the expiry of the agreed term. First of all, this means that the private partner is no longer entitled to receive payment from the exploitation of the facility; second, the private partner is obliged to pay damages for the breach of contract. The breach of contract was justified by a more convenient pending business opportunity which called for a relocation of the private partner's human resources and logistic capacities onto another more lucrative project; the profit margin from that project enabled the private partner to incur considerable financial gain, even after paying damages for the breach of contract.

In the PPP context, the direct reason for the occurrence of opportunism is the fact that the selection of a private partner is performed within the competitive, market-based discourse, in the process of a public procurement.[3] On the other hand, negotiations about amending and supplementing a contract are a matter of bilateral agreement. Therefore, the public procurement procedure, which implies the selection of the most favourable (cost-effective) offer in line with

[3] Under the Serbian legislation, the public procurement procedure on awarding the right to carry out a PPP project is regulated by the Public-Private Partnership and Concessions Act and the Public Procurement Act (Official Gazette of the Republic of Serbia, No. 124/2012) which the PPP Act explicitly refers. The Public Procurement Act is incorporated by reference in the content of the PPP Act. The wording of the PPP and Concessions Act leads to the following conclusions: the provisions of the Public Procurement Act regulate the procedure for awarding a public contract to carry out a PPP project without the elements of concession; the provisions of the Public-Private Partnership and Concessions Act regulate the procedure for entering into a public contract on a PPP project with the elements of concession (Cvetković & Sredojević, 2012: 49).

the market-based criteria[4], is replaced by bilateral agreements, in which case the private partner essentially has a monopoly (considering the private partner's lack of flexibility in terms of finding a new contractor within the specified time limit).[5] Given the lack of proper methodology, the contract proceeds are redistributed in favour of the private partner, which ultimately entails "less value for (taxpayers') money" and results in economically inefficient administration and procurement of services of public interest.[6] The likelihood of opportunism arises from the fact that public-private partnerships agreements are basically incomplete contracts.

The possible opportunistic behaviour of a private partner in the process of creating a public-private partnership may be regarded as a risk for the public partner. As the binary enumeration of risks includes endogenous and exogenous risks, the risk of opportunism has the characteristics of an endogenous risk which can be prevented (or generated) depending on the way a contract is formed. On the other hand, exogenous risks are a result of unpredictable circumstances which are beyond the influence of the contracting parties.[7]

The opportunistic behaviour of a private partner can occur *ex ante* (before the contract is signed, i.e. during the bidding stage) or *ex post* (after the private and public partners signed the contract).

An example of *ex ante* opportunism is the so-called aggressive (opportunistic) offer by a private partner. In this kind of offer, the bidder (a potential private partner) assumes that he will not be obliged to perform all the contractual obligations either because there is the "asymmetry of information" (a disproportion in the quality and scope of knowledge of public and private

---

[4] According to Article 85, paragraph 1 of the Public Procurement Act, the offer evaluation criteria are: 1) the most favourable (cost-effective) offer, or 2) the lowest bid. The criterion for the most favourable (cost-effective) offer is based on different elements, depending on the subject matter of the public procurement; these elements may be: 1) the offered price set by the bidder; 2) a discount on the prices stipulated in the buyer's pricelist; 3) terms of delivery or performance of services/works, including the minimally acceptable and ultimate time limits which do not affect the quality of goods, works or services; 4) current costs; 5) cost-effectiveness; 6) quality; 7) technical and technological benefits; 8) environmental benefits and environment protection; 9) energy efficiency; 10) post-sales maintenance and technical support; 11) the warranty period and the type of warranty; 12) obligations in terms of spare parts; 13) post-warranty maintenance; 14) the number and the quality of hired personnel; 15) functional characteristics, etc.

[5] For more, see *infra,* in the discussion about the public partner's "hold up" problem.

[6] See *supra* note 1.

[7] This classification is taken from: Radulović & Nenezić, 2012: 195-196.

partners) or due to high transaction costs and/or the political consequences of substituting the selected partner with a new one.[8]

Ex post opportunism (which occurs in the process of putting a PPP agreement into effect) may be illustrated by a restricted number of options available to the public partner in the process of deciding on its course of action (hereinafter: the "*hold up*" problem) in case the contract was breached by the private partner. This issue will be discussed in the next part of this article.

The Public Partner's "hold up" problem

The "*hold up*" problem is a type of opportunistic behaviour of a private partner in the context of public-private partnership relations. It occurs when the scope and the structure of the optimal transaction (including the quality of service, time of delivery, the quantity of products/services) cannot be *ex ante* defined with considerable certainty. [9]

The "*hold up*" problem is a form of *ex post* opportunism of one contracting party stemming from the specific purpose of the transaction elements. Therefore, the other party is in an inflexible position (without alternatives). In the PPP context, this specific feature primarily refers to technology, human resources and the *know-how* of a private partner. The success of the

[8] The relation between the quality and the scope of knowledge of public and private partners in a PPP is called the "asymmetry" of information. For example, in a PPP related to water supply, a public partner has an advantage in relation to a private partner because the former has the knowledge about the quality of the existing infrastructure of the water supply system, its distribution, availability, etc. Local governments have their own ("private") knowledge about the quality of the infrastructure (pumps, pipelines, measuring system); this kind of knowledge is an added value considering that the assessment of the quality of the water supply structure is an excessive financial burden for a private partner (if possible at all); in comparison to electric power plants which are easily accessible, the pipelines of the water supply system are mostly underground, which makes the evaluation more difficult. As opposed to the public partner, a private partner has special knowledge on the technological aspects and modes of funding the water supply project. However, the public partner is not aware of the technological capacities of the private partner, nor is he familiar with the structure of his costs and productivity level; (all this knowledge is in possession of the private partner). As both parties have an "information advantage" in some segments, the information they have on specific issues is asymmetric (Cvetković, 2013). In law, the issue pertaining to the asymmetry of information is partially resolved in the discourse of Game Theory. See: Douglas G. Baird, Robert H. Gertner, Randal C. Picker, 1994. For more information on the application of Game Theory to the structure and concept of public-private partnerships, see in: Ping S. Ho, 2013:175-207.

[9] The paradigm of the "*hold up*" problem dates back to the 1920s. *Fisher Body, a* company specializing in the production of automobile bodies, was the only company which produced components according to the *General Motors* specifications. Given the significant increase in demand for the components, the manufacturer *Fisher Body* took advantage of this unexpected opportunity and increased the cost for the additional quantities of delivered goods. As a result, the *General Motors* took over *Fisher Body* in 1926 (Rogerson, 1992).

public partner's investment depends on the actions of the private partner, who has the knowledge and ability which cannot be easily substituted on the market.

In essence, the "*hold up*" problem in the PPP context refers to a situation where a public partner allows an investor to invest funds into a PPP project, after which a private partner modifies the distribution of benefits so as to gain more profit from the PPP project than he is reasonably expected to collect on the basis of his own investments.

The "hold up" problem has significant effects on the relationship between the contracting parties in a public-private partnership.

First of all, there is a rise in the cost of contract negotiations; in order to avoid the hold-up problem, the public partner takes actions aimed at eliminating the risk of opportunistic behaviour of the private partner. These actions include their own costs, and they eventually fall onto consumers and users of goods and services of public interest.[10] Even if such situations were predictable and clearly stipulated, the contract transaction costs remain high as they include the costs of determining *ex ante* the contract terms through negotiations, the guarantees for contract performance, the *ex post* costs related to modifying the contract given the problems in the enforcement of contractual obligations arising from legal voids and the like.

Secondly, the contract stability and legal certainty are undermined because the private partner is now given an opportunity to be more flexible in accessing his own interest and to make use of the inflexible position (the hold-up problem) of the public partner; namely, the public partner is not in a position to choose an alternative private partner, either due to the extremely high costs of the private partner selection process or because it is highly unlikely that a new

[10] This increase in the contract-related "transaction costs" is a direct result of the intrinsic nature of a PPP agreement, which is largely relation-driven and thus "incomplete" (the consequence of which is that the contracting parties may not predict the changes which may stem from altering the context of the contractual relation. Incomplete agreements define the transaction in which both parties agree that it is impossible or economically inefficient (to an extent which makes the contract meaningless) to *ex ante* define future difficulties and circumstances of the contract (Ayres, Ian & Robert Gertner, 1992: 729-730). The relation-driven nature of a contract is the subject matter of analysis of the theory of relational contracts. The theory of relational contracts was developed as a result of recognizing the existence of the so-called 'incomplete" contracts. As compared to the "complete" contracts, the parties to "incomplete" contracts define only the key elements of the contract; the other elements are subject to silent/tacit agreement on future adjustments. The reason for this approach lies in the fact that a detailed planning of complex contractual relations is financially and logistically demanding. The key to reading a relational contract is an attitude that a contractual relation changes alongside with altering the context of the contractual relationship (Cvetković, 2014). See more about the notion and characteristics of relational contracts in: Macneil, 1978.

private partner (who is supposed to replace the former one after the contract is terminated) would be in the same factual position as the former one.

Finally, the hold-up problem leads to reducing the effects of applying the market-based principles in the process of selecting the most suitable partner; the current private partner has an advantage due to the inflexibility of the public partner who has limited alternative solutions at his disposal. The ultimate consequence is that investments in the public sector have a lower efficiency rate; the "value for money" generated for the benefit of the public sector[11] is inadequate in comparison to what it would be if the "hold up" problem did not exist.

A concrete manifestation of the "hold up" problem in the PPP context is the situation in which a public partner (as the party in the "hold up" position) agrees to modify the contract by introducing changes proposed proposed by a private actor. The feature underlying the parties' agreement in this "hold up" situation is as follows: the agreement is not the result of a market-driven evaluation of the public partner's interests (i.e. the assessment is not based on the "*Value for Money*" analysis). The given consent is a consequence of the fact that a public partner (the consenting party) is not in a position to actually chose the method of exercising his rights (interests) by protecting the initial agreement (contained in the original contract). The decision of the public partner (who is subject to the "*hold up*" situation) to terminate the contract would (even in case of a civil dispute) significantly degrade the quality and quantity of performed activities and services provided in the public interest. This degradation is a result of the fact that finding a relevant substitute for an opportunistic private partner in the PPP construction is not a simple task; in addition, the legal remedy for the incurred damage shall not be limited to the award of monetary (pecuniary) damages but it should also include (non-pecuniary) damages for the loss of the public partner's reputation at the "political market".[12]

"Asset-specific investment". The hold-up problem is related to the nature of the investment by a subject whose flexibility is limited; namely, it is an investment without the alternative use value, i.e. an "*asset-specific investment*". Asset-specific investments are permanent investments whose value is smaller or non-existent if they are used in an alternative

[11] See *supra* note 1.

[12] **As contrasted with the benefits from economic activities, the benefits of the public actors are not measurable.** The political "market" (which *is* the place where the "goals" of public actors are achieved) is not expressly regulated by the laws of supply and demand.

way (which is not stipulated in the contract). The re-use of asset-specific investments (beyond the form of exploitation envisaged in the basic contract) is not possible without the loss of their intrinsic value in case the contract is terminated before the expiry of the agreed term.

The result of an asset-specific investment is the occurrence of *sunk* costs; this term refers to irreversible costs which cannot be recovered. An example of this kind of costs is an investment in the construction of a network for the transport of energy; in case a private partner abandons/withdraws from the project and stops the supply of energy, their prior investments in the project becomes sunk costs; as the network does not have an alternative use value, these costs cannot be redeemed by involving a new private partner. Klein and Leffler (1981, 619) define *sunk* costs as "*the non-salvageable part of an advance commitment.*" Therefore, in case of a "*hold up*" situation, "*sunk*" costs become the (key) argument for the partner who has limited options at his disposal to accept the changes in the contract which are opportunistically proposed by the other partner. The offer of the opportunistic partner is based on his flexible contractual position, as compared to the inflexible position of the other contracting party whose options are limited. This places the market mechanisms into a subordinated position in relation to the opportunism of the party who takes advantage of the "hold up" paradigm in a specific contractual relationship.

Bearing in mind that practice generates different types of specific investment relations, the asset-specific investment may have various forms. These forms can be narrowed down to four types of asset-specific forms of investment:

a) a *situs*-specific form of investment occurs when two facilities are located near each other for the purpose of minimising transportation costs; it occurs when the facilities are not mobile or cannot be relocated due to unsustainable costs of such allocation. For example, if the project refers to the construction of a waste processing facility, the significance of this type of asset-specific feature is extremely high due to the costs of dismantling the facility and its transfer to another location.

b) an object-specific form of investment occurs when specialised equipment is used for the production of certain goods; for example, the efficiency of coal-fired boilers in a power plant producing electric energy from coal (a thermal power plant) can be increased if the boilers are designed for the use of a specific type of coal. However, if the production process involves the use of a type of coal which has not been taken into consideration during the construction of boilers, there is a probability that the working efficiency of these boilers will be significantly reduced due to the distinctive characteristics of the newly-used type of coal (different calorific value, composition and the like)[13]. Therefore, an alternative use of such a facility (the machines and equipment constructed for specific production processes) outside the context of the initial transaction has a significantly lower value.

c) a principal-specific form of investment refers to the user of products of investment (a principal). The investor (agent) has constructed a facility in order to provide a public service to a specific principal. If the relationship between the agent and the principal ends too soon or changes in any way which reduces the economic profitability of the project, the investor (agent) is left with significant capacities but without the possibility to change their purpose. Here is a hypothetical illustration of such an unjust situation:[14] an entrepreneur has constructed a factory for the processing of electronic waste (old mobile phones, computer chips, etc.) under the assumption that he will receive government subsidies for this type of processing (given that removal of hazardous waste is a form of the protection of the public interest). This fact is an important element of the context of the agreement which the entrepreneur contracted with the buyers of raw materials which are manufactured from the processed waste. The absence of government subsidies changes the context of the agreement between the entrepreneur and the buyers of raw materials, whereby the investment is deprived of the substantive cause for which it has been originally made: the investment has been put into effect in order to meet the specifically defined characteristics of the principal (the state government whose policy is to eliminate electronic waste). In this case, the change of the context of agreement is equal to contract abandonment, and the agent is left with the facilities which are useless from the aspect of economic efficiency.

[13] A similar example of a highly specific form of investment is an investment in a waste management facility: **if the facility was originally constructed to be used as an incinerator but has to be transformed into the facility for the production of electric energy, such transformation is financially unreasonable.**

[14] The following example shows that it is also possible for a private partner to experience a "hold up" problem. It should also be noted that there is a possibility of efficient protection of the private partner by using the so-called "stabilisation clause" from Article 52 of the Public-Private Partnership and Concessions Act. See more in: Jovanović, 2012.

d) ***investment in human resources refers to the investment in knowledge, development of subject-specific experts, and building trust through a continual learning process.*** This form of investment occurs when one party values the knowledge of another party more than a third party; for example, the design and development of the model of a specific facility is a complicated and time-consuming process which requires cooperation between public and private partners. Therefore, the private partner gains some knowledge about the needs and ways of satisfying the specific needs of the public partner: it is a "*know-how*" which has no substitute on the market (as the knowledge is available only to the participants of a specific project).

Therefore, asset-specific investments have an adequate market value for partners if they serve the purpose of fulfilling a concrete contract; however, their value is significantly smaller for any third party or for the contracting parties in case the contract is terminated. At this point, there is an issue of the criterion for establishing the difference between the investment value working towards the contract performance (on the one hand), and the investment value in case the asset has an alternative use (if possible at all), on the other hand. This difference may justify the conclusion that an investment is an asset-specific investment. Concurrently, it should be borne in mind that any minor difference between these values is not a sufficient argument for drawing such a conclusion. In order to determine the "asset-specific" value of an investment, the criterion for differentiating between the investment value aimed at contract performance (on the one hand) and the investment value which may have an alternative use (on the other hand) is as follows: an *asset-specific* investment is deemed to be an investment whose value, in the event of being sold to a third party for an alternative use, is lower than the original investment amount. In case of a PPP, this definition has to be aligned with the subject matter of the public partner's investment project; hence, an asset-specific investment refers to the disposition of a public resource for the benefit of a private partner and for the purpose of accomplishing a more efficient performance of public services. The analogy with the this criterion for determining which investment is deemed to be "asset-specific" in the context of a PPP is that, in case a contract with a specific private partner has been terminated, the overall level of quality in performing services of public interest may be lower than the one which was present before the performance of activities was transferred to the public partner.[15] Namely, private partners will tend to use their activities and profit to cover their expenses first (to pay back a loan and to make a profit) rather than increase the value of an investment as such. They do not have such an interest considering the fact that, in the long run, the benefit from an increased value of an investment goes to the public partner (after the PPP expires). The above situation can jeopardise the security and the quality of providing services of public interest; namely, after the expiry of the agreed term for the private partner's exploitation of the facility, there may be some maintenance, replacement or repairs costs which are too high because the private partner did not invest sufficient funds in those activities in the previous period (the private partner had no interest to invest further considering that the ownership of the facility was to be transferred to the public partner).[16]

The previously described evaluation of the difference between the investment value serving the purpose of contract performance and the the value of investment which may have an alternative use makes sense if it is performed *ex ante*; when the result of such evaluation show that an investment is an asset-specific one, it is necessary to apply a methodological mechanisms in order to prevent the risk stemming from the aforementioned investment feature.[17]

The consequences of the "hold up" problem. Legally speaking, the "hold up" problem is manifested as a disruption of the contractual balance. This imbalance can also be anticipated: a potential contracting party shall not enter into the agreement because he anticipates that, once he performs his due obligation, the other party will pursue the modification of the contract and thus disrupt the originally agreed contractual balance. In case of a public-private partnership, an "asset-specific" investment by a public partner implies the disposition of a public resource for the benefit of a private partner. This disposition *per se* does not create a "*hold up*" situation. Namely, the problem of limited options in a PPP has its dynamic genesis. In the first phase, a private partner first acquires specific knowledge about the project, which is his comparative advantage in relation to other private partners who are interested in continuing the activity after

[15] In the context of the legal system of the Republic of Serbia, the sub-criteria for determining the quality of the performance of an activity should be the same as the criteria for the most favourable offer, as prescribed in the Public Procurement Act (whose norms are incorporated by reference in the content of the Public-Private Partnership and Concessions Act, which includes a referral to the provisions of the Public Procurement Act). See *supra* note 4.

[16] See more on the lack of necessary investing in the described situation in: Robert E. Scott & Paul B. Stephan, The Limits of Leviathan: Contract Theory and the Enforcement of International Law, 2006.

[17] See more about the methodology *infra* in the discussion about the methodology of overcoming opportunism.

the expiry of the original contract between public and private partners; (it implies knowledge about the structure of network facilities in infrastructure projects, the necessary investments needed for maintaining the level of provided services, establishing and developing contacts in a relevant markets of goods and services, the coordination with activities conducted by a private partner in other projects, etc.). Having all this knowledge, in the second phase, the private partner is in a position to use the "inflexibility" of a public partner who is not in a position under reasonable conditions, to easily replace the former private partner with a new one via market.[18]

The anticipation of the "*hold up*" problem in the process of deciding on the implementation of a PPP project may result either in the public partner's withdrawal from the investment or in the decline of the investment efficiency. In the former case, the withdrawal is caused by the public partner's incapacity to eliminate the "hold up" problem by using a specific methodological approach (allocation of risk, insurance, bank guarantees). Ultimately, the result of the decision not to invest is the lack of the sustainable renewal and development of the public sector. In the latter case, even if the public partner opts to perform activities or provide services of public interest either independently or by using the loan capital, the fact is that the described forms of investment will not be optimal if the "value for money" analysis shows that a higher value is earned for public resources in case the project is carried out in the form of a PPP.[19]

Methods of overcoming opportunism

Opportunism is an inevitable working assumption in process of contracting. Yet, opportunism may be limited or even fully excluded from contractual relations[20] by means of

[18] For more about the imbalance of negotiation power as a result of a "hold-up" situation, see: *Posner*, 2010:118.
[19] See *supra* note 1.
[20] One of the mechanisms for acquiring this knowledge is the competitive dialogue procedure. The Public-Private Partnership and Concessions Act expressly recognizes the competitive dialogue procedure (see: Article 23, paragraph 2, item 2, of this Act, Official Gazette of the Republic of Serbia, No. 88/2011), which is elaborated in detail in the Public Procurement Act (see: Article 37 of the Law, Official Gazette of the Republic of Serbia, No. 124/2012, passim). It is a procedure whose primary purpose is the realisation of long-term infrastructure projects and other projects of public interest, and projects which are in modern market-based economies realised in the form of public-private partnerships. In essence, a competitive dialogue enables the public partner to act as a private partner in the course of the selection process proceeding; he is able to search for the best possible solutions available on the market in order to satisfy his own needs. The effects of a comparative dialogue can be illustrated by the following example: in PPP projects, there is a risk that some technology, which has been defined as relevant in the contract with a public partner, becomes outdated in the contract period. This situation occurs if a public partner, while defining the conditions for the participation in the process of selecting a private partner, has left out the

cooperation and the mechanisms for discovering relevant information in the process of drafting a contract (in order to curb the problem of the asymmetry of information).[21] Ultimately, the lower level of opportunism enables the optimal level of investments.

The problem of opportunistic behaviour is resolved *ex ante* by stipulating relevant provisions in the contract between the public and private partners. The *ex post* method, which is reflected in the use of market mechanisms and the process of selecting a new partner, is of no significance for the concept of a PPP; if such a possibility existed, the question of opportunism would not be raised at all since the public partner would not experience a "hold up" problem.

Firstly, the contract clauses can be used to secure that the public partner keeps the benefits arising from the results of a PPP. For example, if a PPP is related to the field of waste management, the public partner can prevent opportunism by retaining the ownership right over all facilities and mechanisation (subject to the terms of contract) which were in the private partner's possession at the moment when the contract was terminated prior to the expiry date. This significantly reduces the likelihood of the private partners' opportunistic behaviour. An example of the "retention of benefit" clause is a contractual provision which regulates the issue of transferring a project from the existing to a new private partner who has been selected after the contract with the existing private partner has been terminated. Namely, given that the realisation of a PPP project requires cooperation between public and private partners, the latter acquires some knowledge about the requirements and methods of fulfilling contractual

obligation of interested parties to replace their existing technology with the new one if the existing technology becomes outdated during the contract period (the risk of outdated technology). For the public partner, this lack of this obligation creates "known- unknowns"; in general, a technological development may occur during the implementation of a PPP project; (the longevity of these projects only increases the probability). Anyway, the public partner may underestimate this risk or may not have enough information about it. When such technology becomes outdated, the public partner finds himself in the position where he has to pay to the private partner the same amount which he could have used to buy more advanced and more efficient technology (if he had provided himself with such a possibility *ex ante*). Concurrently, public partners from other countries (in case of international competition) or other local communities (in case of the national market competition) use the new technology or pay a lower price for the old technology (which is lower than the one paid by the public partner who has not anticipated the possibility of replacing the technology). Therefore, in essence, a public partner who has not anticipated the possibility of replacing the outdated technology may potentially suffer economic deprivation. This situation may be overcome by a competitive dialogue if the participants are required to specify the technology which they will use in a specific case, providing extensive information about its origin, characteristics, the deadline of technological depreciation, etc. Using these data, the public partner can evaluate with more certainty the probability of risk stemming from the outdated technology. For more on the competitive dialogue procedure, see: Veličković, 2013, pp. 526-538.

[21] For more about the asymmetry of information, see: Cvetković, 2013.

obligations towards the public partner. This knowledge is highly specific: it refers to a "*know-how*" which is acquired in the course of contract performance. The transfer of this knowledge requires an active attitude of the titleholder of that knowledge (the original private partner). This active attitude has to be defined as a contractual obligation of the original private partner, which implies a specific sanction if the original partner does not fulfil his obligations during the "transitional period" (the period of transferring the contract from the former to the new private partner). This sanction has to be actually applicable and independent from court mechanisms (for example, retaining a certain amount of the due payment if the original private partner does not fulfil his obligations during the transitional period).[22]

Secondly, an opportunistic behaviour may be prevented by imposing an obligation upon a potentially opportunistic partner to "pay the price" for his own opportunism. Thus, contractual clauses may include provisions defining the securities for the public partner, which imply the payment of monetary compensation by the private partner in case the contract is terminated before the expiry date. These securities must be credible: a credible security instrument is the one which provides for the full compensation of the public partner, in case the contract has been breached/terminated by the other party before the expiry date (for example, the obligation of paying damages for the breach of contract by a private partner who breached the contract without cause). In legal terms, a credible security instrument is the one which makes the termination of contract unsustainable from the perspective of the private party who acts opportunistically. The legal credibility is a consequence of the economic credibility of providing securities for the public partner. The economic credibility of securities makes the breach/termination of contract an unprofitable option for the private partner, which (in turn) diminishes the likelihood of his opportunistic conduct. At this point, it should be noted that the contract may be preserved (even if the private partner insists on the termination) by ensuring the financial support of a PPP project financier. The financier may "enter" into the agreement only providing that there is a direct contract between a public partner, a private partner and a financier in accordance with Article 49, paragraphs 3-6 of the Public-Private Partnership and Concessions Act.[23]

---

[22] The described retention of benefit by a public partner is also applicable in case the selection of a private partner is a result of the expiry of the PPP contract (and not necessarily due to the breach or termination of a contract).
[23] See an extensive analysis of this option in: Nenezić & Radulović, 2012, page 65.

An opportunistic behaviour can also be prevented by providing contract clauses which define the consequences of an initially opportunistic offer by a private partner. For example, a private partner has been authorized to carry out a PPP project after making an aggressive (opportunistic) offer and bidding a lower price. The offer is based on the expectation that the public partner will find himself in a “hold up” position as soon as the parties embark on the contract implementation, (either due to the fact that the private partner eventually gains relevant project knowledge which is unparalleled on the market or given that the process of replacing the existing private partner would be financially and logistically draining to an extent that makes the effort inconsequential. The private partner will take advantage of this new (anticipated) position of the public partner by requesting some changes in the terms of contract for his own benefit. The likelihood of the private partner’s opportunism, which is based on the “hold up” position of the public actor, may be reduced by introducing a relevant clause in the model contract (which is defined *ex ante* in the process of selecting the most favourable private partner); this clause shall stipulate that the private partner has the right to change the original terms of contract only if the the contract implementation costs exceed a specific percentage of the contract value. If the agreed percentage limit is high (e.g., 10 percent or above), it will influence the private partner’s decision to withdraw his initial opportunistic offer; yet, if he decides to stand by the aggressive (opportunistic) offer, the project business results may turn out to be less lucrative than he anticipated when placing the aggressive offer. For example, if he has made an aggressive bid by stipulating a lower contract value and the contract implementation costs eventually exceed a specific percentage (which is lower than the agreed percentage limit stipulated as a requirement for changing the contract terms), he is at a loss because he is not entitled to change the contract. Considering the fact that he may not pursue the change of the contract value as long as the contract implementation costs do not exceed a specific percentage, he will not be able to transfer the costs of his *ex ante* opportunism (prominent in the bidding phase) onto the public partner by demanding *ex post* (after being authorized to embark on the implementation of the contract) the increase of the contract value.

Proofreading: Gordana Ignjatović

BIBLIOGRAPHY

Ayres, Ian, and Robert Gertner. 1992. Strategic contractual inefficiency and the optimal choice of legal rules. *Yale Law Journal* 101:4: 729-773.

Benjamin, Klein and Leffler, Keith B. 1981. The Role of Market Forces in Assuring Contractual Performance. *Journal of Political Economy* 89:4: 615-641.

Douglas G. Baird, Robert H. Getner, Randal C. Picker, 1994. "Game Theory and the Law", Harvard University Press.

Jovanović, Marko. 2012. Osvrt na stabilizacionu klauzulu u Zakonu o javno-privatnom partnerstvu i koncesijama [On the Stabilisation Clause in the Public-Private Partnership and Concessions Act]. *Pravo i privreda* 4-6: 658-673.

Lepotić-Kovačević, Branislava. 2012. Delatnosti od opšteg interesa i javno-privatno partnerstvo u oblasti energetike u propisima Republike Srbije [Activities of public interest and the Public-Private Partnership in the field of energy resources in the regulations of the Republic of Serbia]. *Pravo i privreda* 7-9: 590-609.

Macneil, Ian. 1978. Contracts: Adjustment of Long-term Economic Relations under Classical, Neoclassical, and Relational Contract law. *Northwestern University Law Review* 72: 854–905.

Nenezić, Dragutin & Radulović, Branko. 2012. Analiza mogućnosti i modaliteta finansiranja i mera finansijske podrške javno-privatnog partnerstva u Srbiji [Analysis of options, financial models and financial support measures in public-private partnerships in Serbia. *Квартални монитор* No. 30: 62-71; http://fren.org.rs/sites/default/files/qm/L2_3.pdf accessed on 12th March 2015.

Ping, S. Ho. 2013. Game Theory and PPP. In *The Routledge Companion to Public-Private Partnerships*, Eds. Piet de Vries, Etienne B. Yehoue. pp. 175-207.

Posner, Richard, A. 2010. *Economic Analysis of Law.* Aspen Publishers, 7th ed.

Radulović, Branko & Nenezić, Dragutin. 2012. Novi regulatorni okvir za javno-privatno partnerstvo u Republici Srbiji: Učenje na sopstvenim ili tudjim greškama? [A new regulatory framework of Public-private partnership in the Republic of Serbia]. *Uskladjivanje poslovnog prava Srbije sa pravom Evropske unije*. Vuk Radović (ed.), Pravni fakultet Univerziteta u Beogradu, Beograd, 2012: 190-219.

Rogerson, W.P. 1992. Contractual Solutions to the Hold-Up Problem. *The Review of Economic Studies*, 4(59): 777-793.

Scott, Robert E. & Stephan, Paul B., 2006. *The Limits of Leviathan: Contract Theory and the Enforcement of International Law.* Cambridge University Press.

Cvetković, Predrag & Milenković-Kerković, Tamara. 2011. Javno-privatno partnerstvo: polazna razmatranja [Public-private partnership: initial considerations]. *Pravo i privreda* No. 4-6: 758-770.

Cvetković, Predrag & Sredojević, Sladjana. 2012. *Javno-privatno partnerstvo:priručnik za sprovodjenje na nivou lokalne samouprave [Public-private partnership: a handbook for implementation at the local governments level].* Stalna konferencija gradova i opština – Savez gradova i opština Srbije, Beograd.

Cvetković, Predrag. 2013. Teorija igara kao analitički okvir javno-privatnog partnerstva. [Game Theory as an analytical framework of Public-private partnership]. *Zaštita ljudskih i manjinskih prava u evropskom pravnom prostoru: tematski zbornik radova*. Pravni fakultet Niš: Vol.3 241 - 255.

Cvetković, Predrag. 2014. Ugovorni režim javno-privatnog partnerstva: sui generis karakter kao posledica holističkog pristupa [The Contractual Regime of Public-private partnerships: *sui generis* character as a consequence of the holistic approach]. *Zbornik radova Pravnog fakulteta u Nišu* No. 66: 111-127.

Prof. Predrag N. Cvetković, LL.D.
Associate Professor,
Faculty of Law, University of Niš,
pepicvetkovic@gmail.com

OPPORTUNISM OF PRIVATE ACTORS IN PUBLIC-PRIVATE PARTNERSHIPS

Summary

Public-Private Partnership (hereinafter: PPP) is a framework for resolving the tension between the public and the private sector, primarily for the purpose of raising the quality of establishing, accomplishing, protecting and developing the public interest. The participants' relations in public-private partnership are strained by conflicting interests. The organizational structure and the *modus operandi* of the public sector are aimed at protecting, accomplishing and developing the (general) public interest. The private sector is based on private initiative, primarily aimed at making a profit.

The interest-driven rationality of the PPP actors largely determines the potential for their opportunism. The opportunism of a private actor in a public-private partnership is reflected in his tendency to demand from the public actor to act in a manner which is contrary to the governing PPP principles stipulated in a PPP contract. This contract includes explicit provisions on the public procurement procedure for selecting the most favourable (cost-effective) offer in line with the market-based criteria. Yet, the public procurement is replaced by bilateral agreements where the private partner essentially has a monopoly. Thus, given the lack of proper methodology, the contract proceeds are redistributed in in favour of the private partner, which ultimately entails "less value for (taxpayers') money" and ultimately results in in economically inefficient administration and procurement of services of public interest.

The opportunistic behaviour of a private partner can occur *ex ante* (before the contract is signed, i.e. during the bidding stage) or *ex post* (after the private and public partners signed the contract). An example of *ex ante* opportunism is the so-called aggressive (opportunistic) offer by a private partner. In this kind of offer, the bidder (a potential private partner) assumes that he will

not be obliged to perform all the contractual obligations either because there is the "asymmetry of information" (a disproportion in the quality and scope of knowledge of public and private partner), or due to high transaction costs and/or the political consequences of replacing the selected partner with a new one. *Ex post* opportunism (which occurs in the process of putting a PPP agreement into effect) may be illustrated by a restricted number of options available to the public partner (the "hold-up" problem) in case in case the contract was breached or terminated by the private partner.

The "*hold up*" problem is a form of *ex post* opportunism of one contracting party stemming from the specific purpose of the transaction elements. Therefore, the other party is in an inflexible position (without alternatives). Essentially, the "*hold up*" problem in the PPP context refers to a situation where a public partner allows an investor to invest funds into a PPP project, after which a private partner modifies the distribution of benefits so as to gain more profit from the PPP project than he is reasonably expected to collect on the basis of his own investments.

The "hold up" problem has significant effects on the relationship between the contracting parties in a public-private partnership. In the long run, the hold-up problem leads to reducing the effects of applying the market-based principles in the process of selecting the most suitable partner; the current private partner has an advantage due to the inflexibility of the public partner who has limited alternative solutions at his disposal. The ultimate consequence is that investments in the public sector have a lower efficiency rate; the "value for money" generated for the benefit of the public sector is inadequate in comparison to what it would be if the "hold up" problem did not exist.

The problem of opportunistic behaviour is resolved *ex ante* by stipulating relevant provisions in the contract between the public and private partners, such as: the clause which ensures that the public partner retains the benefits arising from the results of a PPP, the clause which imposes an obligation on the a potentially opportunistic partner to "pay the price" for his opportunism, and the clause which defines the consequences an initially opportunistic offer made by a private partner and has a pre-emptive effect on the possible opportunistic behaviour.

Proofreading: Gordana Ignjatovic