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The impact of public procurement and rules of government contracting on public spending and attracting private infrastructure investment

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The rules on public procurement and Government contracting can have a significant impact on the capacity of a country to attract private infrastructure investment. However, these rules are often influenced by certain attitudes or sectorial interests that generally escape detection. It may come as a surprise to some that such type of investments is not seen as a panacea for a country's development problems, or as an uncontroversial means to speed up investments in more developed countries. It may be useful, therefore, to identify the reasons for the opposition to private infrastructure investment.

This paper is mainly based on the work done by the author in 2000 in the drafting of the rules and model agreements for an Argentine public private partnership ("PPP") system, finally embodied in Executive Decree 1299 of 2000. However, presentation of these ideas in Latin American fora showed that the issues that arose in Argentina may be present in a wider geographical context.

1. Non legal factors

Let us address first, then, some non legal factors that have a deep influence both on the text of the public procurement rules that are applied to public infrastructure projects, as well as on the manner in which these rules are applied.

The first question is whether a country's Government sincerely wants private investors (which in some countries means foreign investors) in the infrastructure sector. The Government may so declare, sometimes at the urging of multilateral institutions, but when it realises what private investment entails for the Government, or for some of its sectors, it may not be too keen to pursue this alternative.

This is because private investment in the infrastructure sector forces the Government to abandon certain powers that it enjoys when resorting, instead, to loans to finance public investment in the sector. Among these we can mention: the power to award the different contracts that are needed to build and operate the project throughout its life (instead of awarding a one time all-encompassing contract such as a concession); the power to appoint persons to the board of directors and executive functions of the operating company; the power to over-staff the operating company and thus use it as a means to combat regional unemployment; and the power to set the rates according to political, and not to economic, criteria.

Of course, the Government can retain some of these powers when it sets the conditions of the main contract. It can keep a part of the shares in the operating company and thus some board seats. It can decide to pay itself the consideration for the services rendered by the operating company and thus keep its hands free to charge the public rates set on political grounds. But the Government can never enjoy the full powers of the operator of the project. Seldom will "authentic" private investors allow the Government to keep a controlling stockholding, as they will fear that their natural expectation of profits will be sacrificed to the natural wish of the Government to defend public interests, whether long or short term, as construed by the same Government. By "authentic" I mean investors who contribute important amounts of equity without relying on Government loans or guarantees, and without expecting to recover most of such equity by being awarded the construction of the project.

Project finance depends greatly on firm contracts being respected by the Government. This may clash in certain countries with the traditional attitude of the public works authority of interfering with the contract to keep it attuned at all times to the perceived public needs. In a public works contract, in which the contractor is paid as the work progresses, this interference does not pose mayor problems for the contractor, and may even be a source of profit for it, as the contractor can charge the costs increases resulting from the changes required by the authority. The situation is radically different in a project finance scenario, since the amount of finance is limited and changes during construction can both impose costs that go beyond such limit as well as delay the start-up of the project and the correlative commencement of the stream of payments which will reimburse the lenders.

Firm contracts are as good as the parties who sign them. In a country with a domestic construction industry that is not fully developed, there may be few, if any, construction companies which can offer firm bids that the banks will find reliable. Therefore, resorting to project finance mechanisms to build public works may leave out a great part of the local construction companies to the benefit of a few major ones and, especially, of contractors from more developed countries. The choice of project finance mechanisms may therefore be resented by the local industry and may not be seen with sympathy by those sectors of the Government dedicated to the promotion of domestic companies.

In certain countries, in a public works contract most of the risks are assumed by the Government. This is especially true with the risk of delays caused by unforeseeable situations, such as unexpected sub-soil conditions, archaeological findings, the need to respect "first nation" rights or, in federal countries, a lack of coordination among the zoning authorities of the different jurisdictions. In a project-financed work, these risks which, at the very least, delay start-up and thus affect the expected repayment schedule, inevitably have to be distributed among the constructors, the banks and the investors. While the host Government may assume some of them according to the terms of the contract, this may change a commercial risk into a sovereign risk, an outcome which may be welcomed in some countries but not in others depending on the creditworthiness of the host Government. Moreover, the whole public-private-partnership mechanism is based on the concept of passing to the private investors the risks that they are more qualified to assume or to control.

It should come as no surprise, therefore, that in certain countries the domestic construction industry will favour public works contracts over project finance mechanisms that limit or exclude its participation or impose on the industry risks that it is not accustomed to face.

We should now look at the way these non-legal factors may influence the text of public procurement and Government contract rules and their application.

2. Legal rules

a) *Public procurement rules*

We will consider first public procurement rules, restricting our analysis in this section to the procedures on competitive bidding, to deal later with the rules that apply to the substantive aspects of Government contracts.

The first issue is whether public works carried out by means of a project finance system can be awarded through competitive bidding. In France, the traditional rule was that concessions -which historically has been the French contract used to channel project finance operations- could not be the object of a competitive bidding, since the choice of the concessionaire was based on the special characteristics of the contractor and not on a monetary comparison. However, new legislation has forced French State entities to apply a special kind of competitive bidding in this case also.¹

In a country where the honesty of Government officers is distrusted, with or without reason, contracting authorities may not like to use mechanisms such as the public private partnership that allow great latitude to bidders to tailor their proposals to the announced public needs. This makes monetary comparison very difficult, or even impossible, so contracting authorities may fear accusations of favouritism in the negotiations that necessarily must precede the award of the contract.

¹ See LAURENT RICHER, DROIT DES CONTRATS ADMINISTRATIFS, 4th ed., Paris, 2004, 512-13.

Two types of competitive bidding mechanisms that rely on a purely monetary consideration may be thought of as compatible with public works that are to be project-financed. The first is to award the contract to the bidder who offers to charge the lowest price (e.g. tolls, rates, etc.) for the output or services rendered by the project. Another is to fix the price of the output at the outset and award the contract to the bidder who offers to pay the highest price to the Government, either up-front or in instalments throughout the life of the operation of the works. Both systems present problems.

Awarding the contract to the bidder who offers lower rates, or higher payments to be made after start-up, risks rewarding the “biggest liar” unless the Government has the discipline and political strength to refuse to renegotiate during construction and thus risk the delays and political criticisms resulting from a change of contractor mid-stream. Charging a price to award the concession may be illegal in some countries. Assuming it is legally possible, if the price is to be paid up-front, the aforementioned problem disappears but domestic companies may be excluded from the competition due to the higher access of investors from First World countries to the international capital markets.

Awarding project-financed works by means of a merely monetary comparison often requires a prior stage of selection on bidders based on certain required qualifications. The choice of such qualifications is discretionary but if the discretion is abused perfectly acceptable bidders may be left out. Thus, having financial statements audited by one of the major international firms, which would appear in its face as a reasonable standard, may put those State companies from First World countries which are audited by an agency of the Government, out of the running.

“Buy national” rules in the applicable procurement regulations, to the extent they are allowed by the treaties which bind the host country, are an obvious mechanism to exclude foreign bidders. But the exclusion may be more devious. Thus, allowing a short time to present the qualification documents and the bid, and requiring cumbersome formalities to be fulfilled (e.g. translation and legalisation of by-laws) effectively excludes all those companies who had not been made aware of the competition beforehand. Also, a cultural gap exists between companies from certain countries accustomed to return with their comments the official draft of the contract attached to the bidding specifications, and the rules that require that the bid conform strictly to the specifications, including any draft of contractual documents to be used.

Delays in deciding the award, with the consequent need for bidders to extend the term of their offers, is another deterrent for foreign contractors, especially when the local economic conditions are subject to sudden changes.

Finally, a caveat with respect to non clear drafting. Governments often are not monolithic nor all their agencies may agree with the same perception of the advantages or disadvantages of private infrastructure investments. Treasury officials may welcome firm contracts, as they know the cost of mid-stream changes. Project finance also allows them to postpone expenditures for budget purposes and avoid increased borrowings. Other sectors of the Government, instead, may find that project finance limits their powers, as it has already been explained. Unless a tight discipline is exercised by the Executive, different sectors of the Government may be working at cross purposes with respect to a given project. As “ambiguity breeds consent”, this conflict often gives rise to obscure, contradictory or ambiguous contracting rules. Bidders should beware that in some countries the rule *contra proferentem* does not apply to the Government and thus doubts will be resolved against the contractor on the theory that it is only entitled to that which is clearly and expressly granted.

b) *Government contract rules*

The French doctrine of “contrats administratifs” is followed in many Latin American countries and in some European ones as well.² According to this doctrine, as applied in Latin America, the Government contracting party enjoys certain powers over the contractor, who is itself subject to limitations on its rights compared to those of a party to a purely private contract. Some European countries that follow this

² On the Argentine theory of administrative contracts, see Héctor A. Mairal, Government Contracts under Argentine Law: a Comparative Law Overview, 26 Fordham Int. L.J. 1716 (2003).

doctrine have recently put certain limits to these rules.³ These powers and limitations can be spelled out in the bidding regulations and specifications or may be sprung upon the contractor after the award.

The most important of those powers are the ones to change the contract to cater to the perceived changes in public needs, and to terminate the contract for reasons of public interest. Compensation must be paid in both cases to cover the increased cost of the performance, or the damages caused by early termination, as the case may be. However, this last rule may not give full protection to the contractors for two reasons. First, loss of profits may not be recognized. But, more important, compensation often requires a lengthy lawsuit which may take ten or more years.

An important limitation on the rights of the contractor is the very restricted role that the *exception non adimpleti contractus* plays in contracts which are deemed of an “administrative” nature. In Argentina, this defense against an action for breach of contract, which defense is based on plaintiff’s own breach, is not admitted, in principle, in administrative contracts unless the Government’s default is of a nature which makes performance by the contractor impossible.

But the main consequence of the existence of the theory of the administrative contract is to “administrativise” all the contractual relation, thus turning into “administrative acts” all Government decisions related to the contract. This, in turn, means that such decisions enjoy the presumption of validity that extends to all Government decisions and forces the contractor to challenge them in a matter of days as otherwise they would be considered final and valid. Not too many contractors wish to antagonise its Government counterparty filing such challenge, so in practice these rules force the contractor to accept as valid many Government decisions that affect the contract even if they are not fully in accordance with its terms.

The impact of the theory of the administrative contract upon project finance for public works can be considerable. If the legal rules are spelled out in the bidding specifications, or incorporated by reference by citing regulations that include such rules, foreign contractors, specially those coming from countries that do not apply this theory, may refuse to participate. Domestic contractors, who know how those rules are applied and can count on some tolerance from the Government, are not similarly dissuaded. Thus, the theory of the administrative contract can act as a non-tariff barrier to foreign investment in the infrastructure sector.

Of course, not all countries who apply this theory suffer similar consequences. If a country has a tradition of respect of its contracts, a professional civil service and a reliable and independent court system, the impact of the theory may be minimal. Therefore, to determine the “bankability” of a project the analysis should not be limited only to the rules applicable to public procurement and government contracts, but should take into account the broader institutional features of the host country.

Another attitude that can dissuade private infrastructure investment is the excessive zeal of Government officers who draft the contract terms, even without applying the theory of the administrative contract. High penalties for delays or minor breaches, and limited rights for the contractor in case of Government default or of early termination for reasons of public convenience, are a common feature. The price increase and the restriction on competition brought about by these rules are seldom perceived, but the peace of mind of the drafting officer in being seen to defend the national interest as well as the position of power which said rules grant to the Government contracting officers are deeply appreciated by the bureaucracy.

Some countries have tried to overcome perceived deficiencies in their internal judicial and administrative structures by resorting to bilateral investment protection treaties. The case of Argentina, who has more than 40 arbitrations currently pending which invoke said treaties, shows that their mere existence may not constitute a sufficient deterrent to allegedly infringing conduct by the host country. Time will tell whether the remedies afforded by these treaties are effective and also whether they are here to stay as criticism of these treaties and of the way they are being applied by arbitration panels is growing in certain less developed countries.

³ See the Spanish Government Contracts Law of 1995, as amended.

Chile has been very successful in using project finance for its infrastructure works. Over six billion dollars have been channelled into its road network by private investors. One of the features that may have contributed more significantly to this success is the setting up, simultaneously with the signing of the contract, of an arbitration panel to resolve the disputes between the Government and the concessionaire. This has been perceived by the investment community as a guarantee of the fair and quick resolution of such controversies. The lack of power of the Government to amend the contract unilaterally or terminate it for reasons of public convenience, is another important feature for the investors.⁴

3. Conclusions

Pacta sunt servanda: this is the main rule needed to allow project finance in the infrastructure to develop. Other legal rules may be helpful as, for example, a law exempting the lenders who step-in from the tax and labour liabilities of their initial counter-part, as otherwise it is difficult to imagine that step-in rights may be effectively used. But most problems can be solved by contract drafting. Therefore, if the lenders can trust that the contract terms will not be changed mid-stream, the bankability of the project may pose no legal problems. But if the legal regime in force or the legal culture of the host country, allows the Government to exercise the traditional power of the administrative contract without providing a fast dispute resolution mechanism, some projects will find no bidders, while others will only be carried out at an increased cost.

If the Government wishes to retain its special powers vis a vis the contractor, it should advise so clearly in the bidding specifications. Surprising the contractor with powers based on legal theories not spelled out in the bidding documents can only provoke surprise and probable litigation. This is sometimes the case of those countries whose successive Governments have different political views on private infrastructure finance, as the contractual safeguards that are accepted by one administration may be overruled by the following one.

In the long run, fair terms work to the benefit of the Government. Not all projects can be financed through a PPP or similar mechanisms. In some cases, such as hydroelectric dams given the importance of the construction risks, resorting to a public works contract, with the Government assuming most of the risks, may be the cheapest -or the only- available alternative. But project finance properly and fairly used allows a country to tap more widely the resources of the international capital markets. It would be a pity if this mechanism were not fully exploited due to certain legal theories or the overly protective attitude of Government officers.

⁴ These facts are taken from a presentation of Marcos Rios at the 2007 Spring Meeting of the ABA in Washington, D.C.