Holdups and Non-standard Breach Remedies in Delegation Contracts

Christophe Defeuley

cired (ehess and cnrs)

December 1998, Revised Version

1 Introduction

Transaction Cost Economics is a microanalytic enterprise to understand the efficiency of alternative modes of governance\(^1\) in relation to the attributes of transaction (Williamson (1993a), p. 101). Transaction Cost Economics identifies three generic modes of governance, which are supported by distinctive forms of contract law. The classical contract pertains to market governance, the neo-classical contract to trilateral/bilateral governance (also states as non-standard governance) and forbearance contracts to unified governance (Williamson (1991b)). Classical contract law supports anonymous, simple, standard transactions. Legal rules are applied in a strict and formal manner. Neo-classical contract law makes it possible to tackle idiosyncratic transactions, executed under conditions of uncertainty, where parties are inclined to be opportunist. Forbearance contracts support highly idiosyncratic transactions, which cannot be handled by neo-classical contract law. Unified governance structures allow ongoing relations to be sustained in an administrative form of adjustment process. One of the major insights provided by Transaction Cost Theory is a consideration of the variety of legal rules, and the observation that contract laws are not always implemented in a low-cost way. Furthermore, the analysis is not restricted to standard contractual relationships. It also includes the governance of complex and incomplete contracts, which are supported by a discrete legal framework.

---

\(^1\) Thanks to the participants of the CIRED workshop and two anonymous referees for criticisms and remarks. This paper has benefited from my collaboration with Mehrdad Vahabi. I am responsible for all the remaining errors.

---

*The institutional matrix within which transactions are negotiated and executed* (Williamson (1979), p. 239).
Nevertheless, one may consider that the legal scope of the transactional approach is somewhat limited. Rather than exploring alternative legal approaches, Williamson refers to different types of contracts which allegedly belong to the very same broad legal apparatus coined by Posner as “modern American business law” ((1993), p. 84)\(^2\). This raises an important issue: is Transaction Cost Economics able to tackle legal frameworks other than those supporting Williamson’s classification of governance structures? The purpose of this paper is to bring a new understanding to this question by applying Transaction Cost Economics criteria to the French administrative legal context. This legal apparatus does not only treat administrative issues such as the organisation of public bodies, their role and area of jurisdiction, their relationships with customers and other institutions. It also provides a set of rules and contractual modes framing the economic transactions between public institutions and private companies\(^3\). The paper focuses on one particular form of these administrative modes of governance: the delegation contracts used for the provision of public services by private companies in the water management sector. Delegation contracts are non-standard governance modes which exhibit unusual features. They are not supported by a private apparatus and do not develop a limited adaptive potential. The distinguishing features of delegation contracts suggest that non-standard contractual arrangements are not always hybrid governance modes. A general overview of French administrative law and delegation contracts is presented in section 2. Section 3 analyses delegation contracts as non-standard modes of governance featuring self-enforcing mechanisms. Sections 4 and 5 outline their special characteristics. An explanation of these features is given in Section 6.

2 An overview of the French administrative law and delegation contracts

Delegation is a general term covering four main contractual forms, which differ in some characteristics, but rely on the same principles. The first is called gérance (management contract). Under this contract, the local authority transfers the entire operation and maintenance function of the service to the private company. The risks of supplying the service remain the responsibility of the local authority and the private company receives a fixed payment. The second form, called régie intéressée, is a management contract in which the payment to the private firm comprises a fixed basis plus a productivity bonus. The third mode is called affermage (leasing).


\(^3\) The European Union estimates that the transactions generated by the different public bodies (central government, federal states, public firms, city councils, etc.) represent approximately 15% of the GNP of the member states.
The service is leased to a private firm for operation and maintenance, but the financial risks are entirely borne by the company. Part of the tariff is given to the private company to compensate for full operating costs. The remaining part of the tariff is transferred to the public authority that has financed the fixed assets of the system. The fourth contractual form is concession. Under the concession type, the public authority contracts with a private firm not only for operation and maintenance, but also for the construction of networks, plants or facilities. The company finances the investment costs. Tariffs set by the company are fixed in relation to the recovery of operational and maintenance costs and a full return on capital invested (Coyaud (1988); Auby (1997)). Affermage and concession are by far the most popular delegation contracts. Hence, we will base our analysis of delegation contracts on these two forms of agreements.

One of the key elements of French administrative law is that it developed complete procedures and principles at a very early stage to cover the economic transactions between public authorities and private companies. French law enjoys a long tradition regarding these transactions which has no equivalent in other industrialised countries. This is one of the reasons why delegation contracts are so widely used in France to manage a large number of public services, which is not the case in other countries. State and the municipal services have been delegated in France at least since 1270. In 1666, the first well-defined and reproducible legal rules of delegation were used to build and run the Briare canal. Throughout the nineteenth century, French administrative law clarified, developed and refined the legal terms used in the context of delegation contracts (Bezançon (1995); (1997)).

The range of industrial sectors associated with delegation contracts is too large to be covered in one paper. This is the reason why we have focused our case study on the water management sector (distribution and treatment). Water management is organised at a municipal level, directly by the city councils themselves, or through large syndicates comprising several municipalities. 43% of these local networks, serving over 75% of the French population, are managed by private companies (Barraqué, 1995). Private companies also run a major part of waste water treatment facilities. This market is largely dominated by three private companies. Générale des Eaux provides water distribution for 25 million inhabitants, Lyonnaise des Eaux 14 million and SAUR-CISE together with other smaller firms, 5 million. In other urban service markets, delegation has also achieved a prominent share (see table 1)4.

---

4 In this paper, we have not set for ourself the task of explaining the different technical, institutional or financial reasons which drive the city councils to choose the delegation option (see for example Clark, Mondelo (1997)), nor in developing the discussion concerning the expected superiority of private ownership upon public one in the provision of public goods and services.
Table 1. Private and public management of urban services in France (1997)

<table>
<thead>
<tr>
<th>Delegation contracts</th>
<th>Public management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Collective transport</td>
<td>62%</td>
</tr>
<tr>
<td>Waste collection</td>
<td>50%</td>
</tr>
<tr>
<td>Waste treatment</td>
<td>80%</td>
</tr>
<tr>
<td>Catering</td>
<td>70%</td>
</tr>
<tr>
<td>Water distribution</td>
<td>75%</td>
</tr>
<tr>
<td>Wastewater treatment</td>
<td>60% - 70%</td>
</tr>
<tr>
<td>Parking</td>
<td>65%</td>
</tr>
<tr>
<td>Urban heating Systems</td>
<td>75%</td>
</tr>
</tbody>
</table>

source: Auby (1997)

3 Delegation contracts as non-standard governance modes

3.1 Hostages and credible commitments

Water distribution markets do not represent an interesting portfolio for private investors looking for quick returns, due to the important fixed costs in infrastructure investments. The commercial provision of water has to be organised in such a way that the private company providing the funding and/or the operation of urban infrastructures will be in a position to benefit from a positive return on the capital invested.

a) Contracts are set up with a long-term perspective, on average between 12 (for affermage contracts) to 20 years (for concession contracts). Contract duration is one of the most common features safeguarding an investment-specific relationship (see Joskow (1987)). With such a time-scale, a private company is in position to cover its expenses (in infrastructure maintenance, facility construction, operating activities) and benefit from positive returns.

b) The private company is placed in a monopolistic situation for the duration of the contract. The same company provides all the water to households in a defined area (generally the local authority’s territory). This enables the company to secure important guarantees concerning the demand for a determined length of time.

c) The contracts are signed and renewed without any competitive tendering. The awarding of the contract is framed in an intuitu personae perspective, i.e., by negotiation and mutual agreement (Lorrain (1991)). Local authorities must make a public announcement and adhere to a number of
procedures regarding the selection process. Nevertheless, the final choice depends upon their good judgement. In general, price is a central element of the bid assessment, but it is not the sole factor determining final choice. Public authorities often take into consideration participants' track record, their financial capabilities and their knowledge of local conditions. This gives incumbent firms an advantage over new comers in the renewal stage. During the execution of the contract, incumbent firms acquire appropriate knowledge about local decision-making networks and develop routines and personal contacts with civil servants. They gather a great deal of information regarding the facilities and plants they manage, the problems to be solved and future investments required. Given the local monopolistic position and the length of the contract, the *intuitu personae* principle enables incumbent private firms to create strong barriers to entry (see Aghion et Bolton (1987)).

d) Payment to private companies is based on a “fixed-cost” principle. Payments evolve throughout the duration of the contract according to the following formula.

\[ P_1 = P_0 (a + bB_0 + cC_0 + dD_0...) \]

\( P_1 \) is the price to be paid for period 1, and the price at the beginning of the contract is denoted \( P_0 \). \( B, C \) and \( D \) are indexes representing various cost categories (wages, energy cost, writing off of initial investment). \( b, c \) and \( d \) parameters represent the relative weight of each cost category in the overall charges borne by the private company to run the water distribution network. A fixed parameter \( a \) is used to mitigate a mechanical cost increase. The sum of \( a, b, c \) and \( d \) parameters is equal to 1. In general, the value of the \( a \) parameter is between 0.1 and 0.2. It is set to transfer a part of the productivity gains made by the private company to the consumer. In addition, rendez-vous are periodically organised between parties (each 5 years) to re-examine the financial conditions of the service provisions.

e) The final element used to promote private company involvement is the incompleteness of technical contractual stipulations. The contractual documents do not exhaustively state the detailed specification of services to be provided. The private company should ensure water distribution is provided, whilst respecting some constraints (technical and environmental quality standards), but is not bound to specify what the exact means employed will be.

All these contractual terms can be considered as signals displayed to induce the private companies to become involved in the field of water distribution. Once they having taken part, water companies are secure in the knowledge that they will be in a position not only to benefit from regular positive returns, but also to take advantage of opportunities to hold and strengthen their position against new-comers. Their expectations concerning their future development are positively influenced by several contractual characteristics (length of the relationship, renewal procedures, captive demand,
pricing, technical incompleteness). Firstly, the companies benefit from productivity gains. Secondly, their superior knowledge of networks and facilities allows them to adjust costs and procedures in consequence. Revenues and cumulative experience can be used to win new contracts by proposing low prices, demonstrating serious financial potential, a solid track record and a good reputation. Historically, the French water companies have used this strategy to secure their current leading positions. For example, Générale des Eaux began its expansion with a very small number of contracts in the late nineteenth century (Lyon, Nice, suburbs of Paris). These contracts, periodically renewed, constituted the core of its activities for a very long period (nearly half a century). They offered the company an increase in cash-flow and a well-established reputation during this period (Compagnie Générale des Eaux (1953)), which have been used to gradually secure new contracts.

Following the lines of Williamson's argument (1983), delegation contracts can be seen as credible commitments sustaining the transactions between public bodies and private companies. Buyers (local authorities) offer hostages to suppliers (private companies), to ensure that their involvement in the provision of specialised assets will be secure. Hostages offered by local authorities are the following. City councils enter a long-term contractual relationship with a company. Local authorities transfer not only their experience, facilities and public employees but also their responsibilities regarding water distribution to the private firms. Local authorities lose their direct contact with households. Their ability to monitor price changes throughout the duration of the contract duration is limited. In addition local authorities transfer part of their decision-making power regarding the choice of technical options (in maintenance and investments) to private companies.

The above may pave the way for opportunistic behaviour by incumbent companies. Once guarantees have been given regarding the involvement of an operating company, local authorities have to safeguard themselves against opportunism (Williamson 1996), p. 26). Hostage taking could be strategically used to secure a quasi-rent. One way to overcome this risk is to devise a mutual reliance relation, or bilateral dependency, in which the two parties are reciprocally exposed. On the one hand, the buyer offers hostages and is bound with credible commitments. On the other hand, the supplier is confronted with credible threats restricting his ability to behave opportunistically.

### 3.2 Credible threats to avoid opportunist behavior

In water distribution, contractual relationships involve two specific forms of assets: dedicated assets and site specificity. Infrastructure and networks in water distribution are dedicated to provide one type of service and cannot be used for alternative purposes. "Dedicated assets are those that are put in place contingent upon particular agreements and, should such contracts be prematurely terminated, would result in significant excess
capacity” (Williamson (1983), p. 526). They are also located in a “cheek-by-jowl” relation to each other so as to economise on transportation costs. Localisation of water distribution networks allows the distance of water transportation between production plants and households to be kept as low as possible. Once sited, the assets in place are highly immobile (Joskow (1988), p. 106). Hence, once the contract comes into operation, the operator is in a position to make a strategic use of the infrastructure. The private operator may breach the contractual terms and raise the price of the service provided, up to the point where local authorities have an advantage in using different equipment to deliver the service to households. In water distribution, the potential benefits for an operating company of a hold-up strategy (Alchian et Woodward (1988)) are high, or even quasi-infinite. Hence, opportunistic behaviour – i.e. unanticipated non-fulfilment of the contract – is likely to occur (Klein, Crawford et Alchian (1978)).

Private companies are likely to have more convincing reasons than local authorities to behave opportunistically. Once they have chosen to contract out to private companies, local authorities will not try to take advantage of their position. Their goal is not to breach the contractual terms and to put the private companies in financial difficulties, for example by setting prices covering the operating costs but not yielding a fair return on capital. Local authorities are accountable for the provision of fresh water to households and are considered as the main agents responsible for any disruption to water distribution. A severe and durable reduction of the payments made to private companies will certainly involve a decrease in the sums available to adequately develop and maintain facilities and sustain a high level of quality. In such a situation, the local authorities would suffer two forms of negative financial effects. On the one hand, without adequate maintenance, the infrastructures and networks they own will progressively lose value. On the other hand, if the private company is obliged to cease its operating activities, the city council must without any delay resume the direct provision of water distribution to households. This may involve important additional expenses associated with the rebuilding of capability and technical skills, the hiring of new employees, the gathering of information, the investment in new facilities, etc. One may take the view that, for a local authority, these efforts and costs largely exceed the potential benefits of opportunistic behaviour.

Local authorities must be able to exert a particular strong credible threat to mitigate the risks of ex-post opportunism. French administrative law provides such a credible threat. Local authorities are authorised to make a unilateral statement regarding the pursuance of contractual relationships with the operating company, whilst companies have to respect contractual terms and cannot overstep their rights without incurring penalties (Chapus (1992)). At any time and for a whole raft of reasons, local authorities have the right either to alter certain contractual terms (the unilateral modification power principle), or to suspend the contract (the unilateral cancellation power principle) (Auby (1997), pp. 80-82). The unilateral modification power
principle states that the local authority may force a private company to change the service delivery conditions in the public interest. For example, a local authority may demand that a private company replace the waste water treatment technique in use by another technique, even if this modification is not stated in the contract. In such a case, a modification of the contractual financial conditions may occur.

The unilateral cancellation power principle may be invokes if a private company does not agree to alter the service delivery conditions (refusal to modify the service provision, the technical basis, the number of households supplied, etc.). Furthermore, the local authority can cancel the contract if the private company does not respect the contractual terms (price increases without justification) and / or alters the normal provision of public services. This modification can be obtained through a strategic use of contract incompleteness. For example, private companies can make cheap and obsolete technical choices which jeopardise the long term adaptive capacity of public provision. They can also neglect infrastructure maintenance and public health considerations. In this scenario, local authorities determine the harshness of sanctions to be inflicted upon the private company. These can range from financial penalties to the replacement of the operating company.

One of the key elements of the aforementioned principles concerns the initiation of legal action. Local authorities benefit from the privilege of the prerequisite. Their decisions apply without any delay. A local authority does not have to consult an administrative court before suspending the contract or imposing financial penalties. These decisions may be appealed against by private operators if they consider them unfair, inappropriate or disproportionate. The request will be examined by the court concerned, but without halting the execution of the decision. To date, the deliberations of the courts has never led to the reconsideration of a unilateral sanction imposed by a local authority. We do not have any example of such a decision in French administrative law.

The public ownership of assets ensures the unilateral cancellation power principle effective. Consider the case of a private ownership of assets. Local authorities would no longer be in position to immediately replace the private company. They would be obliged to compensate the private companies for the loss of their assets. This would require a lengthy procedure of hearings and negotiations regarding accountability and a technical assessment of the plants, networks and facilities concerned. Water distribution in the United Kingdom provides an example of a system in which the private ownership of assets does not allow the public authorities to use the range of prerogatives that French city councils possess. In the UK, each water and sewage company holds a licence. Licences are granted for at least 25 years. The Department of the Environment may terminate these licences at any time on or after the expiry of that period (Cowan (1994)). The water utility concerned should be informed at least ten years before termination. This ten year period may be used by the operating company to behave in an opportunist manner.
The ability to use *unilateral cancellation power* can be deemed a credible threat. An opportunistic operating company will not be in a position to use the time-lag and intricacies of the legal process to run the public service to its own financial advantage for any length of time. A breach of the contract’s terms or a strategic use of contract incompleteness may lead to an immediate and irreversible penalty (the loss of the market). *Unilateral cancellation power* acts as a self-enforcing mechanism which affects the potential gains of an opportunist firm (Klein (1996)). With such a mechanism, “the terms of the agreement are such that adherence is more advantageous than violation” (Telser (1980)). There is no room left for an opportunist company to seek a quasi-rent.

a) The *unilateral cancellation power* principle delegated to local authorities by French administrative law is clearly established. It has been repeatedly confirmed when conflict comes before the ultimate French administrative court of appeal, the *Conseil d’Etat*\(^5\).

b) This rule is a matter of *common knowledge* to private companies as well as local authority lawyers. Local authorities have had recourse to the rule in the past and do not hesitate to use it where necessary.

c) Cases of unilateral cancellation are rare. In general, conflicts between local authorities and private companies are resolved before this measure is resorted to. When a local authority requires some important changes in the provision of a service (price reduction, improvement in quality, new investment plan, etc.), a modification of contractual terms is negotiated with the private company. This negotiation may be difficult, the private company may be reluctant to devise a new contract (as recent examples show\(^6\)), but disputes are almost always resolved. The *unilateral cancellation power* principle acts as an incentive for both partners to accept a negotiating common ground and devise a new contractual agreement by mutual consent.

d) In case of unilateral cancellation, the replacement of the incumbent company by direct management by local authorities is generally difficult, because local authorities have transferred a good deal of skills, information and knowledge which cannot be repossessed without important financial repercussions (Clark et Mondello (1997)). Nonetheless, the threat of revocation remains credible because incumbent companies may be replaced by other companies. At a first glance, it might appear that the replacement potential in case of cancellation is reduced by the oligopolistic structure of the French water sector. However, the increasing number of possible entrants, generated by the deregulation of the water distribution sector in Europe, counterbalances the “lock-in” of the French market. For example, newly privatised UK water companies (like *Thames Water*) are now trying to enter the French market. They tend

---

\(^5\) CE 10/01/1902; CE 31/05/ 1907; CE 2/05/ (1958).

\(^6\) City councils of Grenoble, Lille, Bordeaux, Castres, Sète, etc. (1997) and (1998).
to become real alternatives to the French incumbent companies in the eventuality of cancellation.

Credible commitments and threats combined form a self-enforcing feature of contractual relationships. Self-enforcing procedures guarantee that each party will perform according to contractual terms (Klein et Murphy (1997), p. 417). This demonstrates that a transactional explanation is relevant in understanding how the delegation contracts support the economic transactions. They can be considered as an example of non-standard governance modes. By “non-standard contracts” we mean contractual modes which do not solely rely on market mechanisms to support the execution of economic transactions. Non-standard contracts require specialised mechanisms to support the agreement and avoid opportunism. Long-term contracts, reciprocal trading, regulation, franchising and the like, are all examples of these non-standard contracts (Williamson (1991b); Joskow (1988)).

Delegation contracts cannot be considered as examples of hierarchical structures; even if one of the contracting parties comes from the public sector, the relationships between the two transactors are not symmetrical and the disputes are not directly resolved by court arbitration. Delegation contracts are supported by self-enforcing procedures (credible commitments and threats). Conflicts are not resolved by fiat. The parties are not obliged to resolve their differences internally because access to courts is denied. Disputes and friction are generally dealt with through negotiations and mutual agreement, but the arbitration of a court will be necessary in case of serious difficulties (to define an appropriate set of sanctions or to confirm the unilateral cancellation decision made by the local authority). Furthermore, the private company is not placed entirely under the authority of the public authorities. The local authorities can halt or modify the contractual arrangements only on the grounds of public interest. In delegation contracts, public authorities do not exercise a “regulatory authority” (Williamson (1991b)) over private companies without any reference to court arbitration. Their decisions are supported and limited by the French administrative courts, but in a way that differs from commercial law.

In spite of their distinctive features, the delegation contracts appear to be consistent with the transactional approach. This tends to demonstrate that the following central features of Transaction Cost Economics can be generalised outside the framework of modern American business law:

1. Transactors are aware of the benefits of a transaction-cost minimisation solution;
2. They devise special mechanisms to tackle the non-standard features of the relationships;
3. These mechanisms are self-enforcing;
4. There is a strong relationship between the degree of opportunistic risk (as a function of asset specificity) and the nature of self-enforcing instruments (Riordan et Williamson (1985), p. 367).
This last statement merits elaboration. In transactions involving such highly-specific assets, long-term duration is not a sufficient safeguard against opportunistic risks. An opportunist company would find almost no limits to the benefits accruing from its operation: the local authority would be a complete “lock-in” situation. Therefore if contract duration provides the only sanction, the losses for an operating company arising out of a premature termination would be inferior to their gains in the breach. This is the reason why another credible threat (unilateral cancellation power) is used to counter the above. It suggests that credible threats must be as severe as the opportunistic risks are high.

Delegation contracts are non-standard governance modes featuring self-enforcing mechanisms. Nevertheless, they exhibit two elements which do not readily fit the transactional explanation of the nature and potential of hybrid governance modes. They do not operate “in the shadow of the law” (section 4) and do not present limited adaptive capabilities (section 5).

4 Non-standard contracts supported by “legal centralism”

According to Transaction Cost Economics, self-enforcing mechanisms sustain contractual relationships more efficiently than recourse and submission to legal settlement. Courts are not always the most cost-effective institutions to evaluate disputes, to measure performance and determine appropriate sanctions. Courts may not possess a specialised knowledge of the industry concerned, nor grasp all the aspects of a complicated relationship. Special attention has to be paid to the duration of legal procedures in the case of disputes over contract execution. If the time between the beginning of litigation and the final decision imposing financial sanctions is expected to be sufficiently long, a transactor may have the possibility of developing a successful opportunistic strategy. In such a case, courts are not the appropriate instruments to enforce of the contractual terms. They throw the door wide open to opportunistic behaviour.

Therefore, for a contract involving highly specific assets, transactors will not rely solely on legal and formal procedures. They will design a private apparatus (arbitration or self-enforcement procedures) to guarantee the contract enforcement and to mitigate opportunism (Klein et Leffler (1981), p. 616). This does not mean that legal procedures do not play any role. According to Klein (1996), one may consider that self-enforcing contracts are based upon two types of procedures. The first one, the traditional legal procedures (sanctions, resort to the courts), apply to the essential elements of the agreement (explicit and unambiguous performance targets). The second applies to elements which are intentionally left unspecified to give more flexibility to the parties. The elements left unspecified are those which may
be advantageous to re-negotiate if subsequent market conditions deviate substantially from expectations (demand, price, technical aspects). These elements are supported by a private apparatus, which is more flexible than legal procedures and more appropriate to measure performances and provide sanctions. Accordingly, self-enforcing agreements are supported by a mix of legal procedures and private mechanisms.

Delegation contracts are an example of non-standard contracts which do not rely on a non-legalistic apparatus. They are enforced by general legal principles without opening the door to opportunist behaviour. In the case under consideration, credible commitments are supported by the law which frames the contract duration, pricing, renewal procedures, etc. Credible threats play their role because the privilege of the prerequisite is in vigour and permits the execution of legal decisions at low cost and without any delay. Therefore, the mechanisms which can be used by local authorities to impede opportunist behaviour are not privately designed. On the contrary, the legal procedure assuming the role of credible threat (unilateral cancellation power) is sustained and reinforced through common law and jurisprudential doctrine (precedent).

This provides a new solution to the problem raised by Williamson, asking why parties never appear in the courts to resolve their disputes over contract execution (1991a, p. 161). Williamson argues that the transactors tackle the issues privately, through non-legal enforcement mechanisms, because courts do not resolve disputes quickly or cost effectively. Our example shows that the law may ensure contract execution and minimise costs by organising self-enforcing relationships between parties. Hence the rarity of recourse to court arbitration may be considered a consequence of the efficiency of legal procedures to avoid contractual disputes. In this case, self-enforcing features stand within the legal framework.

At a first glance, it may sound strange to argue that a self-enforcing contract does not exist “in the shadow of the law” but relies on legal procedures. What could possibly be the purpose of self-enforcing procedures if legal mechanisms also exist? There is no a priori contradiction between self-enforcement and reliance on legal procedures. Credible commitments and threats can be grounded and executed through recourse to legal procedures. Each legal framework supports two stages of the contractual relationship: the design of contractual terms (entry and execution) and the procedures.

---

7 This was the case with the Dèvile-lès-Rouen court decision in 1902. A dispute arose between a local authority (Dèvile-lès-Rouen) and a gas company at the beginning of the century (1902). The operating company would not switch the lighting service plant from gas to electricity. The local authority decided to terminate the contract and to sign new one with an electricity company (Auby 1997, p. 81). The administrative court in charge of the case acknowledged the right of the local authority to use its unilateral cancellation power and to replace the incumbent company with another partner. The court decision of Dèvile-lès-Rouen in 1902 extended far beyond a narrowly defined influence on lighting service management. It was also of interest to every other public utility. This 1902 court decision provided convincing arguments for every local authority involved in a delegation contract to breach the contractual terms if necessary. The jurisprudential dimension appears to be powerful tool in reinforcing the guarantees regarding the enforcement of contractual terms and the mitigation of opportunism.
whereby disputes are resolved and parties accommodated. It relies upon several types of instruments: the defining of general principles and procedures of court intervention and arbitration, and also the design of incentives to promote the enforcement of contractual terms. Credible threats can be employed as one of the incentive instruments provided by the legal framework to ensure execution of the contract. If the fact that incentive instruments account for a major part of the legal framework is taken into account, then the contradiction between self-enforcement and reliance on legal procedures disappears. Delegation contracts provide an example of agreements supported by legal procedures playing an incentive role.

5 Non-standard contracts featuring strong adaptive capabilities

During the execution of the contract, the contractual terms often have to be changed and adapted to new conditions. Disturbances, and their consequences (indeterminacy in the sharing-out of profits and performance between parties) may lead to the reappearance of opportunistic behaviour, or at least to the appearance of recurrent friction between transactors. Two forms of adaptations – autonomous and co-operative – may occur. Whether adaptations to disturbances have to be predominately autonomous, co-operative or both, varies with the content of the transactions. Each generic form of governance – market, non-standard contract, and hierarchy – systematically varies in its ability to adapt in autonomous and co-operative ways. A series of transaction-cost economizing alignments between transaction and governance structures is obtained. (1) markets align efficiently to autonomous adaptation, (2) hierarchies to co-operative adaptation, (3) and non-standard contracts to a mixture of both kinds of adaptations (Williamson 1991a), p. 171). The hybrid feature of non-standard contract adaptation is the consequence of the very nature of this form of governance, combining access to markets with the existence of a fairly strong administrative order supporting exchange (arbitration or self-enforcing procedures). This non-legal apparatus gives partners a reasonably solid basis on which to negotiate a co-operative adaptation. Nevertheless, this adaptation is limited in its ability to respond to every form of breach. It can be efficient only to a certain degree.

Non-standard contracts provide a tolerance zone (of + / - 10% of the initial contractual terms) within which misalignments are absorbed (Williamson 1991b), p. 272). If operation produces an unexpected new context and parties have non-convergent expectations of the new situation, then the co-operation base may be insufficient to fill the gaps. If immediate gains from defection become superior to the discounted gains from continuation, adaptation efforts will fail to accommodate parties (Williamson 1993b), p. 45). "[..] Neo-classical contracts are not indefinitely elastic. As distur-
bances become highly consequential, so neo-classical contracts experience real strain, because the autonomous ownership status of the parties continuously poses an incentive to defect" (Williamson (1991b), p. 273). In these circumstances of serious disturbances, and even if opportunism does not occur, delays and negotiating costs become so important that hybrid contracts will no longer be the best transaction-cost economising solution. As the risks of facing important and frequent disturbances gain importance in a long-term perspective, one can consider non-standard contracts as transitory governance structures, or at least as second-best solutions. Adaptations to consequential disturbances are less costly within companies mainly because resolving internal disputes by fiat saves resources and involves less friction (Williamson (1991b), p. 280).

The example of the French delegation contracts tempers this point of view. These contracts, albeit non-standard, are able to absorb strong and frequent disturbances and should be viewed as long-lasting governance structures. Two major forms of evidence support this statement.

Firstly, private companies have been able to keep abreast of the qualitative and quantitative evolution of the market. Two broad periods may be distinguished in the development of water distribution since 1950. The first mainly concerned the extension of water distribution networks throughout the country (1950-1975). The second mainly involved qualitative elements: the development of wastewater facilities and the meeting of quality standards set by the European Union (since 1975). In 1954, only 40% of the French population located in rural areas was connected to water distribution networks. Injection of investment by local authorities and water companies increased the connection level of rural areas to 88% in 1976. Now, almost the whole French population (90%) is connected to a mains water supply. Since the mid-seventies, this quantitative effort has been completed by a qualitative improvement in water quality. Several European directives have set maximum levels of concentration covering over 60 parameters. These levels are periodically redefined and enlarged to include new chemical or microbiological substances. The 1991 European directive has also introduced new obligations regarding the treatment of waste water. Each local authority in Europe will have to collect wastewater and to treat it in appropriate facilities by 2000 or 2005 (European Commission (1996))\(^8\). This legislation requires strong adaptive efforts over a relatively short time. From the late eighties onward, meeting quality standards for water distribution as well as for wastewater treatment have become the principal concern of French local authorities and private companies.

Broadly speaking, one may consider that the French operators have been able to meet the new quality standards established since 1975-1980. Despite some local problems due to specific elements\(^9\), almost all the water distribution networks are able to meet these standards. A 1994 study

\(^8\) Local authorities whose population is inferior to 2000 inhabitants benefit from less stringent obligations.

\(^9\) For example nitrate pollution of ground water in the Bretagne region linked to intensive pig production.
covering 38 quality parameters (including bacterial indicators and chemical substances directly related to human health), reveals only 0.3% of non con-
formity over a 3 year period. More specifically, 3.1% of water networks show frequent excesses of maximal concentration of nitrates. Approximately 2% show frequent excesses regarding steel and aluminium (Ministère du Travail (1996)). Thus, the adoption of appropriate wastewater treatment facilities (and the replacement of old ones) has, in the main, been accomplished. This has required considerable investment. The installation of reliable waste water facilities in almost every part of France has been estimated to have cost FF 83 billion for the 1995-2005 period. The 1997 European directive with regard to the strengthening of maximum concentrations of lead in water could involve an additional investment flow of FF 120 billion (due to the replacement of old distribution networks) in the next ten years (Boistard et Guerin (1997)). In common with the majority of European countries, France has been able to organise and finance the complete coverage of water distribution networks (see table 2). The system of contracts has not been an obstacle to the adaptation of quantitative and qualitative market evolution over half a century.

Table 2. Some international comparisons in water management

<table>
<thead>
<tr>
<th>Countries</th>
<th>Prices</th>
<th>Water treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ireland</td>
<td>2.81 FF</td>
<td>67%</td>
</tr>
<tr>
<td>Italy</td>
<td>4.33 FF</td>
<td>75%</td>
</tr>
<tr>
<td>Sweden</td>
<td>4.43 FF</td>
<td>94%</td>
</tr>
<tr>
<td>England</td>
<td>5.18 FF</td>
<td>95%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>5.60 FF</td>
<td>92%</td>
</tr>
<tr>
<td>France</td>
<td>5.79 FF</td>
<td>90-95%</td>
</tr>
<tr>
<td>Belgium</td>
<td>6.42 FF</td>
<td>58%</td>
</tr>
<tr>
<td>Germany</td>
<td>7.52 FF</td>
<td>91%</td>
</tr>
</tbody>
</table>


Prices of water management (distribution and treatment) and the percentage of the population connected to waste water treatment facilities are similar in France, Sweden, England, Italy or Germany. The results are similar, but the organisational solutions are very different. In the large majority of European countries (as well as in the United States), water distribution is managed by public bodies, directly by city-councils or indirectly through public companies (Stadtwerke in Germany, Municipalizzare in Italy). Even if the current general shift towards privatisation calls some of these organisations into question, they are generally considered to be fairly well adapted to tackling the ongoing evolution. Delegation contracts (i.e. a non-standard
contractual arrangements) and public provision (i.e. a unified mode of governance) benefit from equivalent adaptive capabilities.

This is not to say that those different organisational bodies exhibit the same characteristics. When the quality of the service provided is partially unobservable, different governance structures (private or public) may not exhibit the same incentive to invest. The concern of a public hierarchical structure regarding quality improvement (even in the dimension that is not observable) may be important. A private company whose main interest is to reduce production costs and maximise profit may be reluctant to invest (see Hart, Shleifer et Vishny (1997)). Nevertheless, this risk is alleviated by the durable involvement of private companies in delegation contracts. The long-term relationships between local authorities and private companies tend to reduce the incentives to under-invest in quality improvement. Consider a two-period contractual relationship. An alteration in the maintenance of facilities in the first period (corresponding to the duration of the first contract) will certainly create additional expenses for the operating company in the second period (renewal of the contractual arrangement).

The second form of evidence demonstrating that delegation contracts have strong adaptive capabilities is that they are widely and durably used by the French local authorities for the provision of public services. Contractual arrangements are the main governance modes used for the provision of water distribution (75%). Local authorities prefer to contract out to private companies rather than themselves provide these public services through public unified structures. Ceteris paribus, this may indicate that local authorities — which have to make sure that the continuity of public services provision will be preserved — consider that these governance modes are able to deal with potential misalignments and can adapt themselves to consequential disturbances. The stability of relationships shows that private companies and local authorities find a common ground on which to make the required co-operative adaptation efforts. Local case studies in major French cities demonstrates a general trend towards a strong stability of incumbent firms' position (see table 3). The example of the city of Nice is worth mentioning. The city chose to delegate the water distribution network to the Générale des Eaux company in 1864. The relationship between the private company and the city is still ongoing. The initial 1864 contract has been readjusted and re-negotiated 17 times. New contractual relationships have emerged from each stage of the technical evolution of water distribution activities (the creation and development of the water distribution network, the installation of waste water treatment facilities, the raising of quality standards).

In the transactional approach, co-operative adaptation fails because one party finds it advantageous not to respect the contractual terms. In a non-standard self-enforcing contract, poor adaptation occurs because enforcement mechanisms are no longer sufficient to prevent a defection strategy. Threats lose their credibility. They are not able to play their role in the new contractual situation, which may allow future profits to exceed the sanction that will be imposed by termination (Klein et Murphy (1997), p. 417). But
Table 3. Some examples of the duration of urban services contracts

<table>
<thead>
<tr>
<th>Firms</th>
<th>Local authorities</th>
<th>Activities</th>
<th>Contracts duration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lyonnaise des Eaux</td>
<td>Levallois-Perret</td>
<td>Waste collection</td>
<td>since 1937</td>
</tr>
<tr>
<td>Lyonnaise des Eaux</td>
<td>Courbevoie</td>
<td>Waste collection</td>
<td>since 1942</td>
</tr>
<tr>
<td>Lyonnaise des Eaux</td>
<td>Neuilly</td>
<td>Waste collection</td>
<td>since 1937</td>
</tr>
<tr>
<td>Générale des Eaux</td>
<td>Brionne</td>
<td>Water distribution</td>
<td>since 1933</td>
</tr>
<tr>
<td>Générale des Eaux</td>
<td>Suburbs of Paris</td>
<td>Water distribution</td>
<td>since 1923</td>
</tr>
<tr>
<td>Générale des Eaux</td>
<td>Suburbs of Lyon</td>
<td>Water distribution</td>
<td>since 1949</td>
</tr>
<tr>
<td>Générale des Eaux</td>
<td>Nice</td>
<td>Water distribution</td>
<td>since 1864</td>
</tr>
<tr>
<td>Générale des Eaux</td>
<td>Rennes</td>
<td>Water distribution</td>
<td>since 1890</td>
</tr>
<tr>
<td>Générale des Eaux</td>
<td>Nancy</td>
<td>Bus transportation</td>
<td>since 1896</td>
</tr>
<tr>
<td>CISE</td>
<td>Dinard</td>
<td>Water production</td>
<td>since 1929</td>
</tr>
</tbody>
</table>

Source: personal information and Cour des Comptes, 1997

If self-enforcing mechanisms are not subject to misalignments caused by serious disturbances, then a strategy of defection will not become profitable, and the contractual scheme will be able to cope with the requirements of co-operative adaptation. This is the case with French delegation contracts. Credible threats work efficiently in each likely scenario. Local authorities can make discretionary use of penalties and sanctions. They are not constrained to adhere to contract clauses listing each class of possible opportunistic moves (price increases, inappropriate utilisation of the assets) associated with certain forms of sanction (a range of financial penalties). Instead, they may unilaterally decide the degree of sanctions to be used for each observed disturbance. Their unilateral cancellation power is quite sufficient to cope with unexpected disturbances. Local authorities are in a position to bridge every gap which can occur between misalignment and sanction, which could lead to a profitable strategy of defection.

6 Lessons from the delegation contracts

The specific characteristics of delegation contracts provide the starting point for a more general discussion regarding two distinguishing elements of Transaction Cost Economics: (a) the relationships between law and contractual modes, (b) the hybrid nature of non-standard contracts.
6.1 The mutual influence of law and governance structures

General legal principles do not impede non-standard contract enforcement and adaptation. On the contrary, they ensure an efficient co-operative adaptation by implementing credible threats which can be applied to almost every type of situation. In our example, legal principles are well-suited to resolve contractual difficulties. The main reason is that the legal apparatus does not function as a rigid body of assumptions and principles. It has to adapt itself to three distinctive developments. Firstly, it has to cope with continuous changes in contract engineering. Secondly, the legal apparatus has to deal with the general evolution of water management activities. Thirdly, general legal requirements are influenced by jurisprudence and common law.

a) The different type of delegation contracts (gérance, régie intéressée, affermage and concession) are the products of a long historical process of contract engineering. Each of the distinguishing features of these contractual modes have been precisely designed between 1880 and 1914. Their major characteristics have been determined through a trial-and-error process involving local authorities, private companies and administrative law specialists. For example, private companies faced real difficulties when they tried for the first time to apply concession contracts in water distribution activities in the late eighteenth century. Even if the first concession contract for water distribution in France was signed in 1777 in Paris, it was not before the second half of the next century that the rules and legal procedures of concession contracts were sufficiently elaborated to permit private firms to operate and develop the water networks in response to economic and financial conditions (Bezançon (1995); (1997)).

The purpose of this contractual engineering process was not to challenge or to replace legal centralism by a private legal apparatus. Its goal was to enrich the contractual modes within the framework of administrative law by modifying certain of their major features or by creating new ones. In the nineteenth century, the régie intéressée contractual mode was elaborated from concession cases in which the required investments had been made by private companies but the new facilities were financed by local authorities. The distinction between concession and régie intéressée, defined and enforced by the law, permitted an enlargement of the range of delegation contracts and matched the specific demands and situations of each local authority more appropriately.

b) The development of the management of public services by private firms requires specific adaptations of the contractual modes employed. Over the last 30 years, delegation contracts have been applied to new activities (waste management, catering, city-cleaning, street parking, etc.). In some urban service markets this enlargement has required the creation of new contractual modes. For legal reasons the traditional concession or affermage contracts could not be used to support economic transac-
tions between local authorities and private companies. For example, in municipal waste management activities in France, the lack of a direct financial link between private companies and households was considered by administrative lawyers to be an obstacle to the application of traditional delegation contracts. This difficulty was overcome by designing new forms of contract which followed the traditional contractual modes in their principles whilst differing with respect to their characteristics. A new delegation contractual form (called Bail Enphythéotique), equivalent to concession contract, was designed in 1988 in order to meet the requirements of waste management. This tends to demonstrate that contractual modes adapt themselves to the attributes of the transactions they support.

c) The general legal requirements are influenced by jurisprudence. Precedent provides a precise definition of the range of actions which can be left to local authorities in the case of conflicting situations with private companies. The intervention of jurisprudence also guarantees the implementation of central legal principles such as unilateral cancellation power.

The legal principles and the contractual modes jointly evolve to cope with the historical and sectorial evolution of transaction characteristics. Sometimes, it appears that the contractual modes in action are not adequately aligned with the attributes of the transaction. In such cases, local authorities and private companies do not set up a private ordering apparatus, rather they require contractual engineering to realign the governance structures and the transactions. This is feasible only because administrative law is not a rigid body of assumptions and principles. The notion of delegation contracts itself is not absolutely fixed. It may evolve together with the contractual engineering and the scope of application of these delegation contracts (Delcros et Peyrical (1994); Delacour (1997)). This explains why non-standard contracts are not designed and enforced in “the shadow of the law”.

6.2 The distinction between non-standard and hybrid governance modes

Delegation contracts show that the Williamsonian analysis of governance modes can be usefully further developed. Transaction Cost Economics considers non-standard contracts as governance modes located between market and hierarchy, which are supposed to be poles apart. This is the reason why non-standard contractual modes are also defined as hybrid governance modes. "The hybrid mode is characterised by semi-strong incentives,

---

10 In water distribution, payments to private firms are made directly by households (they pay water bills to the firms). In waste management, payments are generally indirect. Households pay a waste collection tax which is collected by local authorities. Local authorities use this tax to pay private firms' activities. However, in some cases, households can pay the private company directly (pay by the bag) (see Fullerton, Kinnaman, 1998), but these systems are not widely used in France.
an intermediate degree of administrative apparatus, displays semi-strong adaptations [...] and works out of a semi-legalistic contract law regime" (Williamson (1991b), p. 281). Following this definition, we cannot consider delegation contracts as hybrid governance modes. Those contracts display strong adaptive capacity and rely on a complete legal contract regime.

This contention leads us to go beyond the analysis of non-standard contracts. Transaction Cost Economics is no longer bound to consider – by construction – non-standard contracts as hybrid governance modes. Non-standard contractual relationships are not doomed to fail in the face of strong disturbances. Our example shows that this is not a dedicated feature of this governance mode. It is rather a consequence of the existence of a private legal apparatus, which cannot cover all the strategic dimensions of a changing environment. If non-standard contracts are supported by efficient and well-adapted general legal principles, then the incidence of misalignment decreases and co-operative adaptability can be reinforced. This allows us to describe non-standard contracts as long-lasting governance structures. They are not just hybrid modes, they cannot be reduced to a combination of the distinguishing attributes of market and hierarchy. To gain more theoretical substance, they have to be analysed more independently from the two polarised reference points.

7 Concluding remarks

This paper provides an analysis of the relevance of Transaction cost Economics in the French administrative legal context. Confronted with contracts supported by legal principles differing from those of modern American business law, the transactional approach can be applied, provided some adjustments are made. Delegation contracts may be considered as examples of non-standard self-enforcing agreements. Two results should be underlined. Firstly, self-enforcing mechanisms are supported by general legal principles. Secondly, these contracts are stable governance structures, which can cope with strong misalignments. These conclusions lead to a distinction between non-standard contractual modes and hybrid governance structures. This distinction could be an interesting starting point, extending beyond the transactional approach which locates non-standard contractual modes between market and hierarchy. A more complete theoretical treatment of this type of contract may provide us with a better understanding of such contractual modes as delegation contracts, that represent a real alternative to hierarchy as a mechanism for coping with long-term co-operative adaptation.
References

Chapus R. (1992), Droit administratif général, Paris, Montchrestien
Clark E. et G. Mondelo (1997), An option approach to water delegation, Nota di Lavoro 85.97, Milano, Fondazione Eni Enrico Mattei
Compagnie Générale des Eaux (1953), Brève histoire de cent ans. 1853-1953, Paris
Delacour E. (1997), La notion de convention de délégation de service public, thèse de doctorat, Paris


Ministère du Travail (1996), *Programme d’amélioration de la qualité des eaux destinées à la consommation humaine*, Paris


