MANAGING PRE-CONTRACTUAL AND POST-CONTRACTUAL OPPORTUNISM IN BEE DELIVERY IN PPPs.

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Abstract

Since the promulgation of the generic Black Economic Empowerment (BEE) legislation in South Africa, opportunism is known to abound. It is here demonstrated firstly, that pre- and post-contractual opportunism, which comes in the form of "adverse selection" and "moral hazard", seems to be highly mitigated in Public Private Partnerships (PPPs). Secondly, there appears to be a strong fit between PPP legislation and the Principal Agent theory requirements for mitigating opportunism occasioned by information asymmetry. The strength of the PPP legislation in this regard translates into better procurement processes and correct structuring of the contract, entered into by the government (the principal) and the consortium (the agent). The benefits accruing from this manifest themselves in better screening mechanisms that induce better signalling from the agents, pre-contractually. Post-contractually, the monitoring systems embedded in PPP contracts ameliorate BEE shirking and align principal/agent interests. The objective is therefore to use the Principal Agent theory to assess the efficacy of the Public Private Partnership (PPP) legislation in mitigating opportunism in BEE delivery.

Keywords: Principal-Agent Theory; Information Asymmetry; Pre-contractual Opportunism; Post-contractual Opportunism.

Introduction

During the period of Apartheid in South Africa, black citizens were prevented from entering the corporate world, attaining a quality education, or having any meaningful self-benefiting role in the economy of the country. Since 1994 the new ANC democratic government has adopted an overarching policy of Black Economic Empowerment (BEE) in order to redress the racial economic imbalances of the past (National Treasury, 2004). Like all affirmative action policies implemented around the world, BEE seeks to regulate the allocation of scarce opportunities in many areas including education, employment, or business in order to increase the representation of persons belonging to certain groups which were previously unfairly excluded (Fryer and Loury, 2005). In South Africa, BEE encompasses women and blacks who, in the South African context, are black Africans, Indians, and Coloureds (mixed-race). BEE encompasses a variety of interventions and measures such as employment equity, skills development, targets for ownership and management, and preferential procurement (DTI, 2004). However, the South African government ironically relies on the well-established white-owned companies to deliver BEE, as they are largely still the entities endowed with relevant expertise and capital, especially

when large infrastructure projects are instigated. In these contracts the government compels the large, historically white-owned companies to sub-contract to the emerging black contractors in order to impart skills as part of BEE policy.

Despite a substantial number of BEE deals since 1994, ownership patterns in the economy have hardly changed (Radebe, 2006) and this reflects continuing low levels of participation by black South Africans in the formal economy (Brown, 2004). The government has come to the realization that in order to effect economic redress it has to be systematic, rather than relying on the goodwill of the previously privileged (IRN, 2005). The construction industry in particular has been slow to increase black participation, especially in management, concentrating mostly on enterprise development. The government has tried to increase black participation by encouraging linkages between large and small construction companies through joint ventures and subcontracting, where large contractors are required as part of the targeted procurement to unpack or unbundle their contracts into smaller contracts to secure the participation of the Affirmable Business Enterprises (ABEs) (Department of Public Works, 2002). Work done by Gouden (2000) has demonstrated that joint ventures and subcontracting benefit SMMEs in transferring expertise, provided the contract is properly structured.

Under South Africa's targeted procurement programme, the responsibility for the successful empowerment of the SMMEs is by and large ceded to the private sector. The main contractor in most contracts functions as the implementation agent on behalf of the national government in achieving the long-term objectives of upgrading SMMEs. This scenario, where the government is the principal and the contractor is the agent, is a typical economic Principal-Agent Theory relationship which is invariably bedevilled by the concomitant problem of opportunism. Opportunism may manifest itself pre-contractually in various forms of strategic misrepresentation of the true beneficiaries of the BEE contractual "set asides", or post-contractually through tokenism, which is characterized by superficial inclusion of historically disadvantaged individuals with peripheral roles in the execution of the contract. All these can be encompassed under an umbrella term of "fronting" which, according to the ICT Empowerment Charter (2005), means *"any entity, mechanism, or structure established in order to circumvent the BEE requirements as required under various government policy instruments".* It is in this context that the South African government has identified the potential of Public Private Partnerships (PPPs) as a suitable vehicle for developing BEE in the country (National Treasury, 2004). In South Africa PPPs are governed by the *Code of Good Practice for BEE in PPPs*, and this paper interrogates the efficacy of this code of good practice in lessening the Principal-Agent problem compared to the traditional forms of procurement in the construction industry.

Research methods

Research hypothesis:

- The Code of Good Practice for BEE in PPPs provides a better procurement mechanism to ameliorate pre-contractual and post-contractual opportunism.

Research Objectives:

- To identify common BEE opportunism in the construction industry.
- To identify the weakness of the traditional procurement methods in mitigating opportunism.
- To assess if the there is fit between the Code of Good Practice in PPPs and the model Principal-Agent mechanisms for mitigating opportunism.

Introduction to the Principal Agent Theory and Opportunism in Construction

The Principal–Agent problem occurs whenever one person (the principal) delegates authority to another (agent) (Surowiecki, 2004). The "problem" in this economic theory relates to the difficulty employers (principals) have in ensuring that employees (agents) making day-to-day decisions act in the best interest of the employers (Gratto et al, 2002). The problem is more acute when the employee or contractor has informational advantage over the principal and has incongruent interests from the principal. Principal-Agent theory describes this relationship using the metaphor of 'contract', thus the focus of the theory is on determining the most efficient contract given assumptions about people (e.g. self-interest), organizations, and information (Eisenhardt, 1989). The most efficient contract will be the one that minimizes the possibility of one party reneging on the original agreements (i.e. that most effectively induce cooperation), such that the gains from the exchange can be maintained. The normal procurement methods in South Africa when it comes to BEE have been shown to have many loopholes during contract implementation, after the initial "apparent" compliance to win the bid.

The Principal-Agent theory is based on three fundamental assumptions, firstly that both parties are rational individuals who are also self-interested and secondly that the agent is both effort and risk averse (Baiman, 1990). Lastly, that there is a persistent problem of information asymmetry. The presence of any one of these in a contract creates the potential for the existence of an agency problem (Baiman, 1990; Eisenhardt, 1989).

Asymmetric information

Asymmetric information occurs when one of the parties has more private information about his abilities or the object of exchange (e.g. the product or service) than the other. Whenever asymmetric information exists it potentially leads to opportunism by the agent and it has been the concern of researchers in this field to find the best way to describe the governance mechanisms that solve this problem. The two kinds of opportunism which are important aspects of agency theory are "adverse selection" and "moral hazard" (Eisenhardt, 1989).

Adverse Selection – Pre-contractual opportunism

This is the condition whereby the principal cannot ascertain if the agent accurately represents his true ability ex ante. This problem, which is sometimes referred to as "hidden information", often leads to an opportunistic behaviour where the agent uses the hidden knowledge to take advantage of the principal (Surowiecki, 2004). In the construction industry it takes the form of strategic misrepresentation of the true beneficiaries of BEE benefits in the contract. The contractor enters the contract with private information that leads them to gain at the government's expense. The different forms of this opportunism are listed in **table 1** below.

Table 1. Construction Industry BEE Opportunism

Pre-contractual opportunism	Post-contractual opportunism
Fronts on paper: where the documents are legitimate but the "owners" are unaware of being shareholders (e.g. black maids, gardeners), have no control in the company, and do not manage any aspect of the company,	Company fronts: contractors claim to be black owned or black empowered but when they are awarded the contract they subcontract a major portion of the works to a white contractor. On paper the majority shares are owned by blacks with whites owning a minority shares, however, the minority shareholders are the majority shareholders in the subcontracted company,
Fictitious companies: where the fictitious black company is established just to win a contract, only for a white company to be subcontracted all the works. The "skeleton" company is used for invoice purposes but all funds accrue to the subcontractor.	Fronts in Joint Ventures (JV): a non-BEE contractor forms a JV with a BEE emerging contractor, only to find that the BEE partner has no meaningful role, or responsibilities in the JV, if given any responsibility it is usually in the provision of labour.
The black people identified by an enterprise as its shareholders, executives, or managers in reality have roles of responsibility that differ significantly from those of their non-black peers;	A BEE subcontractor only conducts peripheral functions and does not perform the core functions reasonably expected of other, similar, enterprises,
The black people who serve in executive or management positions in an enterprise would in reality be paid significantly lower than the market norm.	A BEE enterprise relies on a third-party to conduct most core functions normally conducted by enterprises similar to it,
	A BEE subcontractor cannot operate independently without a third-party, because of contractual obligations, or the lack of technical or operational competence,
	Black contractor compelled to accept the subcontract at lower rates while the main contractor charges the government much higher rates,
	Black sub-contractor used primarily as a conduit of money to a white contractor whom he is compelled to, in turn, sub-contract.

Moral hazard – post contractual opportunism

This occurs whenever the principal is not aware of the extent of work he has delegated and the agent takes an advantage after the contract has been entered into (Venkatesh, 2003). The biggest incentive for the agent to behave opportunistically is that his actions cannot be easily observed by the principal and he does not bear the full cost of his actions. Since this takes place post-contractually the agent can even hold-up the principal since he now has monopoly, being the only agent dealing with the principal on the contract. Even if the principal is not happy about the agent's performance he now has to balance getting a new agent against the switching costs he has to incur. In the South African construction industry when it comes to BEE, moral hazard manifests itself in chiefly the ways listed in table 1 above.

Mitigating opportunism

The principal is never in a good position ex ante to know the true quality of the agent before the start of the formal relationship, because the skills the agent has are "hidden characteristics" (Keil, 2005). Much opportunism can be eliminated by introducing competition among the candidate agents, to assess who is best suited to meet the principal's needs. During competition the agent is compelled to "signal" his type to the principal which will go a long way in mitigating "adverse selection" (Spencer, 1973). Another way of avoiding "adverse selection" is to "screen" the agents (Stiglitz, 1975). However, the prevalence of BEE opportunism under traditional procurement

mechanisms would seem to strongly indicate that they do not induce enough "signalling" and the "screening" is not sufficiently thorough to weed out the BEE opportunists ex ante.

Signalling

Signalling is based on the idea that the agent during competition will choose an action that will credibly signal their private information (Keil, 2005). In other words, in their tender documentation these privately informed individuals will adopt a behaviour (signal) that will indicate whether they are the kind of person the principal would want to contract with or not. If proper mechanisms are in place, the individuals will self-select themselves, as those with the desired qualities will stand out from the rest. In the construction industry BEE, there appears to be a prevalence of malicious compliance with tender requirements just to get the contract with no real commitment to deliver on BEE principles ex post. The agent gives out the right "signals" which they later renege on, once the contract starts and this is also a sign that the mechanisms are not sufficiently stringent to compel agents to abide by their original commitments.

Screening

Screening helps in ascertaining the agent's appropriateness and suitability for the job, by inducing him to publicize the private information he possesses about his abilities or the object of exchange (product or service) (Rothschild and Stiglitz, 1976). Prequalification is normally used to screen out those who cannot meet the pre-specified criteria. In traditional construction procurement methods prequalification is not widely used, unless the job is large, and when it is used it is primarily for technical assessment rather than BEE grounds. Consequently companies who are not committed to BEE end up being awarded contracts even though BEE is one of the primary socio-economic goals of infrastructure provision in South Africa.

Post-contractual monitoring

In order to mitigate the moral hazard problem, the actions of the agent need to be monitored after the signing of the contract (Holstrom, 1979). Monitoring is crucial as a feedback mechanism since contracting is an ongoing process. The principal can either engage in "oversight" himself (police patrol oversight) or engage the services of a third party (fire alarm oversight) (Kiewiet and McCubbins, 1991). The great number of complaints and reports on the contravention of BEE principles could directly result from poor monitoring of the initiative ex post. Monitoring is very crucial in controlling the agent behavior and curbing post-contractual opportunism.

Post-contractual incentivisation

If incentives ex post are structured correctly it should be possible to induce the agent to behave exactly the way the principal would act in the same circumstances, had he been equipped with the necessary skills and knowledge (Laffont and Martimort, 2002). This can be achieved by structuring the payment system to be dependent on the observed outcome of the task, thus making the agent the residual claimant of his own effort. If the reward structure is thus aligned with performance, the conflicts of self-interest are reduced. In the traditional procurement system in South Africa, BEE compliance is not rewarded as part of the payment structure ex post, nor is non-compliance which reneges on the bidding stage commitments penalized, commitments which were the very basis of the contract award.

Designing opportunism mitigating contracts

Closely attached to the above point is the issue of designing the most efficient contract. Of the two types of contracts: behavior based (salaries) and outcome based contracts (commissions,

stocks), the behavior based contract creates a moral hazard as it does not induce the agent to work hard because of the assured remuneration (Suzuki, 2003). Behavior based contract aligns principal/agent interests, especially when the principal has verified that the agent behaves in the best interest of the principal (Eisenhardt, 1989). In order to achieve this, sometimes the duration of the contracts has to be such that the agent has enough time to deliver on the contractual obligations. Long-term contracts allow both parties to set milestones and measure success over a long period and it also allows corrective measures to be implemented. This is more pertinent where soft outcomes which involve team effort are envisaged. BEE is such a soft outcome yet most of the infrastructure contracts by nature are of a relatively short duration to enable even the cooperating contractors to have adequately imparted skills to the BEE beneficiary players.

Research results

Public-Private Partnerships (PPPs) efficacy in BEE opportunism mitigation

This section describes the results of a desk study to asses the fit between the prerequisites of Principal-Agent Theory model procurement stages and the mechanisms of *Code of Good Practice for BEE in PPPs*. The fit is depicted in Fig 1 below. This code applies to all government departments, constitutional institutions, public entities listed, or those required to be listed who engage in PPPs. According to the Code any prospective project has to go through three phases and four National Treasury approval stages before the preferred bidder can start construction. After the approval of the preferred bidder the project goes through three more phases in its life cycle making six in all. The Code provides a balanced scorecard which details the weightings of different BEE elements, but chiefly concentrates on: 1) direct empowerment of the black people through ownership and control of construction enterprises, 2) human resource development and employment equity, and 3) indirect empowerment through preferential procurement and enterprise development. BEE is made to be integral in all phases of the project cycle and to be also contractually binding in all those stages.

Phase I

After the identification of a project the relevant provincial or national department has to appoint a transaction advisor. This is an encompassing term as it involves a whole team of professionals from different disciplines such as law, finance, etc. At this point the main aim of the process even at this early stage could be interpreted as an attempt to mitigate information asymmetry. The government departments who initiate the PPP projects do not normally possess expertise in designing and modeling project processes that could be attractive to different consortia especially where BEE is seen as a risk by some investors. The transaction advisors themselves go through a rigorous screening process akin to the stages discussed below. The objective at this stage is to select a team that has bought in to the idea of BEE and which can show commitment in designing the process. The government at this stage applies the 90/10 rule, 90% is allocated to the technical and financial proposal of the transaction advisory team and 10% to their BEE composition, if the transaction advisor fails to make 60% of the BEE component of the scorecard then their whole bid is rejected. This reduces “adverse selection” on the BEE issue because it is at the centre of government economic policy and only people who abide by it are considered suitable to contract with by the government.

Phase II

This phase is essentially the Feasibility Study stage, which creates a BEE balanced scorecard for the project with clear and appropriate set of BEE elements, targets, minimum thresholds, and pertinent weightings. It is at this stage that the institution identifies what BEE objectives it wants to deliver with the project. It assesses different BEE options at its disposal and identifies pros and

cons of each option and the risks associated with such an option. This is carried out concurrently with the technical and budgetary Feasibility that is required for the project. The government again at this level is lessening information asymmetry in as far as what is practical and feasible with regards to the BEE component of the project. Consortium opportunism will be reduced as the government will be in a better light on what to realistically expect from the bidders.

Phase III

This phase has three stages; the first stage is the Request for Qualification stage (*RFQ*). The RFQ stage is entered into after the National Treasury's approval of the Feasibility Study documentation, which the Treasury assessed for its commitment toward BEE, and the fairness and transparency of its proposed contract. This stage is meant to be an interaction between the government and bidders on BEE where bidders can "signal" their concerns about certain aspects of the BEE requirements. The PPP BEE Balanced Scorecard for the project, developed during the Feasibility Study is availed to bidders for comment. In order for the bidders concerns and misgivings to be accommodated, the bidders must show and that they have requisite BEE characteristics and are committed to the project. Chiefly among their commitments bidders should provide written commitments for BEE participation in the Private Party and the subcontracts, and this should be backed by verifiable company information to substantiate the provenance of BEE credentials. Companies are also required to provide CVs of Black Management Control targets in the Private Party and the subcontracts. This stage is the first of the stages intended to induce BEE "signaling" from the bidders, by so doing "screening" out non-committed bidders, and mitigating strategic misrepresentation of BEE beneficiaries by establishing a firm insistence on the verification of BEE candidates' credentials. This interaction gives the government a realistic expectation of what BEE goals are feasible and this reduces the information asymmetry on the challenges encountered by BEE implementers on the ground.

The next stage is the Request for Proposals Stage (RFP). At this stage the BEE elements are clearly presented based on the outcome of the Feasibility Study and adapted from feedback obtained in the RFQ. In most cases pre-qualified bidders are issued with a draft RFP which contains further refined PPP BEE Balanced scorecard. The BEE elements are further shown on the draft PPP agreement with contractual non-compliance clearly linked to the penalty regime. When further comments by bidders are accommodated by the government institution and its Transaction advisors, care is taken not to compromise BEE. The final RFP with the draft PPP Agreement is then issued at this stage, which appropriately phases certain BEE goals over the project term to accommodate start-up capabilities. Throughout there is a continual insistence on

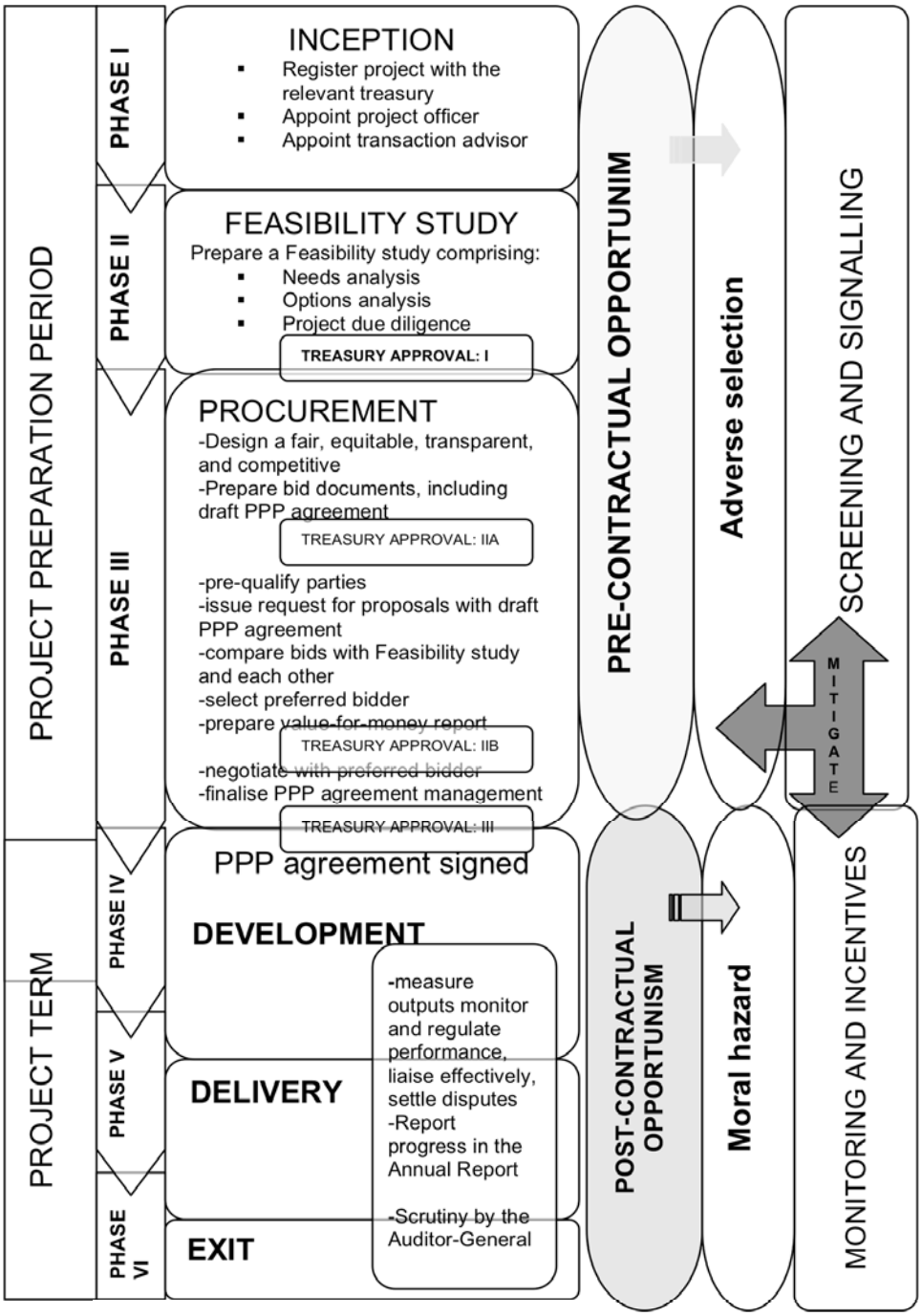

Fig 1. The fit between the Principal - Agent theory and *Code of Good Practice in PPPs*

the verifiable proof of the BEE participants. The main intention of this stage is first to accommodate concerns of the capable bidders, after those deemed not suitable to act in the government (principal) best interest are “screened” out. The second is to adapt the BEE requirements to the realistic market conditions without compromising its goals. This prevents hold-ups where the contractor can claim there is no black expertise in a particular field. Rather the government adopts a stance where little expertise that could be found is grown and nurtured over the project duration. Again this pre-empts any “moral hazard” because milestones are put in place to check progress in this regard. The insistence on verifiable credentials mitigates fronting and the using of purported BEE candidates as financial conduits to undeserving recipients. This stage appears to align the goals of the government with the bidders’ by providing achievable targets

and implementing in phases those that appears to be presently high. Since PPPs are a form of integrated procurement they provide an incentive for the bidders to innovate in order to achieve the contract requirements, and this achieves principal/agent goal alignment.

After this stage if the government questions the general common understanding on certain aspects of BEE implementation then the Best and Final Offer stage is entered into. The government enters this stage if it is felt that for the sake of fairness and transparency the bidders should respond to a further clarification on the BEE elements requirements or if it is felt that there is some information asymmetry favoring the bidders. The bidders will be given a further chance to fine-tune their bids and the government will have a further chance to drive innovation in order to receive the best possible costing in achieving its intended BEE targets. After this stage (if it is utilized at all), the government then enters into negotiations with a preferred bidder. The government negotiation team is warned against claw back on the BEE issue. Since there is no competitive pressure, the private consortium would want to insidiously renege on some BEE elements before the final contract is signed. This is a final stage in a series of stages that were crucial in inducing "signals" from the bidders and it is at this stage that the government ensures that no pre-contractual opportunisms are carried over to the post-contractual stage where they will result in "moral hazards".

The PPP Agreement

Once the contract has been signed the bidder is expected to start with providing the facility as per the terms of the contract and after the completion of construction, manage it for the duration of the concession. Without proper monitoring even the most willing and cooperative agent will find an incentive to shirk. The Code of Good Practice insists on the detailed monitoring mechanisms to curb post-contractual opportunism. This opportunism comes in the form of: fronting companies, black partners only given peripheral roles, over-reliance of black enterprises and subcontractors on white-owned third parties, and unfair remuneration of black entities. To curb all these, the Code specifies that monitoring be modeled in the following fashion:

- The establishment of BEE performance monitoring with clear schedules to commit the Consortium to the BEE targets.
- The clear specification of the reporting requirements.
- The establishment of the empowerment penalty regime that provides for dispute resolution system.
- The setting up of the termination arrangements for non-compliance.
- To oblige the consortium to produce an annual BEE report, detailing its achievement in meeting the agreed BEE targets.
- To provide for regular and 'spot check' reviews by the government institution.
- The provision in the PPP Agreement for the use of independent monitors.

The monitoring regime in PPP seeks to structure the BEE component of the bid in such a way that it can be measured like other components of the bid (construction progress, service provision etc), mainly because any item that cannot be measured cannot be monitored. This differs from traditional procurement approaches that provide for no structured BEE measurement, thus creating the opportunity for much shirking on this issue. Structuring the BEE component such that it can be measured allows for an objective assessment of progress and the justification of penalties when there is non-performance. In the traditional approach there is no termination allowance related to the BEE non-performance, and this usually leads to audacious shirking at best, manifested in all sorts of fronting and hold-up at worst, with the government just protecting itself by blacklisting such defaulting companies for future contracts. The obligation of the consortium to produce an annual BEE progress report compels the consortium to work hard on the BEE issue because any discrepancy between a report and the departmental review on

progress will lead to a dispute, which in the context of South Africa can lead to a damage of reputation as there is a general buy-in on the BEE policy in the business world. 'Spot Checks' conducted by the government compel the consortium to give BEE beneficiaries meaningful roles in the contract, and remunerate them fairly. Without 'spot checks' the most common practice is to pay black "directors/partners" huge salaries while they have no meaningful role in the company, or to use them as 'token' partners who are always absent from work, only required for attending relevant meetings as part of BEE "window dressing". Independent monitors and periodic reviews could be useful in assessing the skills that have been imparted to BEE beneficiaries. They could also be used in catching those BEE companies which are selling jobs to white-owned firms and circumventing the goals of BEE as an avenue to impart skills to black people. During the reviews, the remuneration of black people could be matched with their duties to see if there are any discrepancies when compared to their white counterparts at the same level of responsibility. The same processes articulated above are followed even during the delivery phase of the project. The delivery phase is the longest of all the phases, the concession being granted for 30 years in some cases, and this acts as a pressure for the consortia not to shirk on BEE because over time they would be exposed as they are locked-in for a very long time.

Discussion and conclusions

Any contract is challenged by the Principal-Agent problem of opportunism where there is information asymmetry favouring the agent. The South African construction industry is especially beleaguered by opportunism which lessens the effectiveness of BEE, a policy which is at the centre of the government economic redress. The current legislation using traditional procurement methods has not properly adapted to the new BEE climate, as all the mechanisms are still slanting towards pure infrastructure provision and do not cater for BEE socio-economic concerns. This weakness is exploited with opportunistic behaviour by agents. The government in this context has identified PPPs as good vehicles for BEE delivery coupled with their utility in providing the much needed infrastructure. To achieve the desired result and to avoid the fronting opportunism endemic in the construction industry the government exploited the unique characteristics of PPPs to design the *Code of Good Practice for BEE in PPPs*. Assessing this Code through the Principal-Agent theory, to interrogate its effectiveness in ameliorating agent opportunistic behaviour both pre-contractually and post-contractually, the following observations were made.

Key Lessons Learned:

- The code provides adequate screening of agents pre-contractually and the several stages taken before selecting a preferred bidder induce repeated signalling from the agents (consortia), which leads to the reduction of information asymmetry and this could reduce adverse selection.
- Using the same selection process for Transaction Advisors as for bidders provides the project with committed and visionary leaders on BEE.
- The monitoring mechanisms are very thorough and they target the known moral hazard behaviours of the agents in the construction industry with regard to BEE.
- The codes are silent on the incentives applicable to align the agent interests with the principal's on the BEE issue.

This study has demonstrated that when a socio-economic requirement like BEE is packaged with infrastructure provision, the implementers of projects will regard it as incidental to the 'main' issue unless there is a rigorous regulatory regime to enforce compliance. PPPs are fairly new in South Africa, and the new code has not been properly assessed in many projects to see how far reaching it is in mitigating BEE opportunism

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