

POST-CONTRACTUAL LOCK-IN AND THE UK PRIVATE FINANCE INITIATIVE (PFI): THE CASES OF NATIONAL SAVINGS AND INVESTMENTS AND THE LORD CHANCELLOR'S DEPARTMENT

CHRIS LONSDALE

According to the UK government, one of the key features of the Private Finance Initiative (PFI) is the scope it provides to transfer risk to private sector suppliers. Under the PFI, public bodies are expected to develop interdependent relationships with suppliers that allow risk to be transferred. However, it is the argument of the author that it will not always be possible for interdependent relationships to be engineered by public bodies – on many occasions, public bodies will find themselves asymmetrically locked-in to their supplier. This situation leads to private sector suppliers becoming dominant in those relationships which, in turn, will allow them to pass back risk and obtain greater returns. As a result, the author argues that it is not a question of whether risk can be transferred under the PFI, but when. This argument is illustrated by use of the contracts managed by the UK National Savings and Investments and the UK Lord Chancellor's Department.

INTRODUCTION

According to the UK government, one of the main reasons why the Private Finance Initiative (PFI) is an effective procurement mechanism is its potential to transfer risk to the private sector (Treasury Taskforce 1997). However, many have expressed concerns as to whether risk does, in reality, get transferred to suppliers. These commentators point to instances where clear breaches of contract are not followed up by termination or even the imposition of contractually agreed penalties. The reason often given by public bodies is that the wider concern of nurturing a long-term 'partnership' has predominated (Ball *et al.* 2000a). This response should not come as a surprise. Genuine risk transfer under many PFI contracts was, and is, always likely to be difficult because the nature of the transactions leads to the public body becoming asymmetrically locked-in to the private sector provider. It is argued here that this matters because suppliers have a propensity towards opportunism.

The idea of post-contractual lock-in and its impact on value for money (vfm) has been discussed by transaction cost economists (TCE) for three decades (Williamson 1975, 1985, 1995; McGuinness 1994; Hansen 2002).

Chris Lonsdale is in the Birmingham Business School, University of Birmingham.

However, much, although not all, of the debate over the PFI has been undertaken without an appreciation of the concept. That (small) part of the PFI literature which has recognized it, for example, Pollock *et al.* (2001), Lane (2001), and Parker and Hartley (2003), has either given it a low billing or, in the view of the author, adhered too closely to the traditional TCE interpretation of the concept. Adhering to the traditional TCE interpretation of the implications of lock-in is problematic because that interpretation does not contain a credible model of intra- and inter-organizational management. There is, in particular, a damaging reluctance to accept the importance of power relations. These flaws in TCE cause it to be over-optimistic about the prospect of 'buying' organizations avoiding asymmetric lock-in in their relationships with suppliers and thus being able to transfer risk and secure good vfm. This is of direct relevance to the PFI as the expectation that risk will be transferred under the scheme is underpinned by the same optimistic logic as that of TCE (Office of Government Commerce 2002; Public Accounts Committee 2003a).

This article therefore presents an alternative framework for assessing the ability of public bodies to transfer risk to suppliers. This framework contains many of the building blocks of TCE, but improves, crucially, upon TCE by incorporating the concept of power with respect to both intra- and inter-organizational management. The incorporation of power into the TCE framework has the effect of making it more cautious in its expectation that asymmetric lock-in will be avoided and risk transferred. Having presented the framework, the article then proceeds to provide two PFI case studies, those involving National Savings and Investments and the Lord Chancellor's Department, that highlight its efficacy in explaining both successful and unsuccessful outcomes.

THE ECONOMIC CASE AGAINST THE PFI: A LITERATURE REVIEW

The initial argument for the PFI related to problems over the UK's public finances (Broadbent *et al.* 2000; Flynn 2002). However, it also fitted in neatly with the political inclinations of the Conservative Government of the time. This government saw a key role for the private sector in modernizing the UK's public services and infrastructure (Flynn 2002). There were, however, disadvantages to increasing the role of the private sector through the PFI. Even the UK government itself never sought to deny that the private sector incurred higher costs (between 1 per cent and 3 per cent) in raising capital (HM Treasury 2000). The emphasis, therefore, was on the claimed (or perhaps assumed) superior capabilities of private sector firms. Those superior capabilities, it was argued, would not only make up for the aforementioned higher costs, but actually produce a result that constituted better vfm than either traditional procurement or public provision – the PFI can replace either (Dorrell quoted by Gaffney and Pollock 1999).

However, ever since its inception in 1992, the PFI has had its critics. There have been arguments on a number of fronts, many of them political,

concerning the proper role of the state and the private sector (for example, Rowland and McFadyean 2002). Yet some have preferred to challenge the PFI on its own terms – that is, they have chosen to attack the economic claim that the PFI is a better mechanism for delivering vfm than traditional public sector procurement or public provision.

This economic case against the PFI is many faceted but appears to mainly consist of the following 8 areas of concern.

1. The aforementioned higher costs of capital incurred by the private sector *vis-à-vis* the public sector (Ball *et al.* 2000a; Spackman 2002).
2. The return on capital that the private sector suppliers will expect to make from their involvement with the PFI (Ball *et al.* 2000a).
3. The relationship of the PFI to the public sector borrowing requirement (Broadbent *et al.* 2000; Public Accounts Committee 2003a).
4. The high level of transaction costs that are incurred by the public sector under the PFI. These are said to be caused by the costs of financial, legal and technical advice, the costs to private sector companies of bidding and the costs of the complex negotiations (Ball *et al.* 2000a; Ball *et al.* 2000b; Froud 2002).
5. The impact of the PFI on the ability of public authorities to co-ordinate public services (Industrial Society 2000; Flynn 2002).
6. The impact of the PFI on employment relations (Sussex 2002).
7. The existence of credible marketplaces in many sectors that the PFI is being operated within (Broadbent *et al.* 2000).
8. A suspicion that the design of some PFI projects has less to do with public need and more to do with generating private sector interest. The Walsgrave NHS PFI in Coventry – a £30 million refurbishment that turned into a £174 million new build – and the Swindon and Marlborough NHS PFI – are both cited as examples of this (Gaffney and Pollock 1999; Froud and Shaoul 2001).

There is also concern over the evaluation process. While not being a driver of cost like the above points, critics of the PFI have argued that the way in which the relative merits of the alternative procurement routes are calculated is deliberately biased in favour of the PFI. Of particular concern are the net present value calculations and the issue of the public sector capital charge (Price and Green 2000; Pollock *et al.* 2002), the argument being that if the evaluation process was undertaken fairly, the inefficiency of the PFI route would be clearly exposed.

A final criticism that has been made against the PFI concerns the issue of risk transfer and is the focus of this article. Risk adjustment is often the factor that argues for the PFI route over other procurement options. However, many have questioned whether the manner in which risk is quantified, *ex ante*, is accurate or even honourable. Suspicions have been aroused in the case of numerous PFI projects, because the figure calculated to reflect risk is just high enough to suggest that the PFI route provides the best vfm (Pollock

et al. 2002; Froud 2002). It has been suggested that the real function of the risk adjustment is to disguise the true costs of the PFI and make it look a more efficient procurement route. Not that it is suggested that the government actively intervenes in such risk calculations – the problem is structural. As it is often a case of ‘PFI or nothing’ for a public body, it is argued that public managers are inevitably going to be ‘biased’ when they calculate risk (Spackman 2002). Public managers, in other words, are put in an impossible position and do not need to be pressured by government ministers.

However, there is a second issue concerning risk transfer. This is the issue of whether it is likely that risk will ever really be transferred to the private sector under the PFI, irrespective of whether or not it is reasonably accurately quantified. The key issue here is lock-in. In many PFI projects, the public body becomes asymmetrically locked-in to the private sector provider extremely quickly – sometimes even before the contract is signed – and is in no position to enforce the risk transfer arrangement. A situation of asymmetric lock-in exists where one party is locked-in to a relationship to a much greater extent than the other party. It is this concern about the PFI that is explored in this article. However, it will be shown that while asymmetric lock-in is a significant issue for the PFI, it is not inevitable. As a result, the view of the author is that it is not a question of *whether* risk can be transferred under the PFI, but *when*. It is also important to bear in mind that lock-in, in general, is not the preserve of the PFI. Traditional procurements can also suffer lock-in problems, although, as we shall discuss later in the paper, the PFI has often made the problem worse.

RISK TRANSFER, THE PFI AND ASYMMETRIC POST-CONTRACTUAL LOCK-IN: A THEORETICAL FRAMEWORK

This section presents a framework (see figure 1) explaining the circumstances when a buying organization is likely to become asymmetrically locked-in to its supplier. Asymmetric lock-in causes the buyer to become dependent on the supplier and empowers the supplier to engage in the relationship on the terms of its own choosing. In the PFI context, this is likely to involve the supplier passing back the risk transferred in the original agreement. As was mentioned in the introduction, the framework contains many of the building blocks developed by TCE, but is much less optimistic than TCE about the ability of managers to avoid asymmetric lock-in.

While the framework is applied to the PFI in this paper, it is applicable to any buyer-supplier relationship in either the public or the private sector. The economic concepts contained within it are generic and therefore universally applicable. It follows from this that the framework does not view PFI contracts as being analytically different from any other type of contracting situation, public or private. It also follows that the framework is only concerned with the different forms of PFI contract (design, build and operate, etc.) in so far as they affect the framework’s generic concepts. Each PFI project, regardless of the form it takes, needs to be judged on its merits.

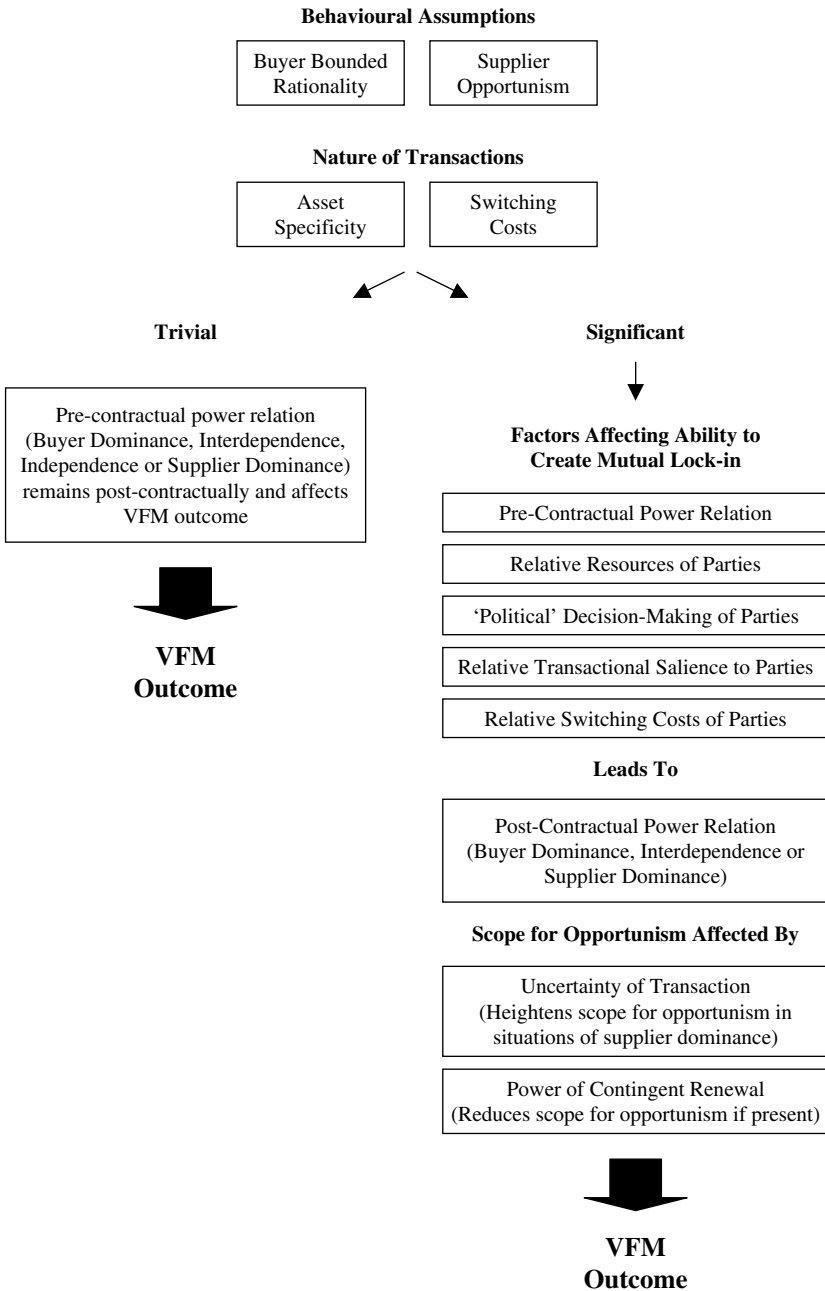


FIGURE 1: A Framework for Assessing the Scope for Risk Transfer

The behavioural assumptions of the framework

The framework is built upon two behavioural assumptions that have been borrowed from TCE. The first behavioural assumption concerns the cognitive abilities of managers. The idea adopted here is that managers operate under a condition of bounded rationality. This concept has been defined as 'a semi-strong form of rationality in which economic actors are assumed to be intendedly rational, but only limitedly so' (Williamson 1985, p. 45). The significance of bounded rationality for the PFI is that it means that managers are unable to sign complete contracts, something commented upon in the PFI literature (Froud 2002).

The second behavioural assumption is the self-interest orientation of opportunism. Opportunism is defined as 'self-interest seeking with guile' (Williamson 1985, pp. 47–8). Williamson (*ibid.*) expands upon this definition: '[It] refers to the incomplete or distorted disclosure of information, especially to calculated efforts to mislead, distort, disguise, obfuscate or otherwise confuse [as well as more blatant forms of lying, stealing and cheating]'. In other words, an opportunistic supplier is a 'wolf in sheep's clothing'; appearances of good faith may be misleading. Indeed, the key to opportunism is that the self-interest is only recognizable after the event. Opportunistic suppliers are always looking for circumstances that will allow them to generate higher returns from a relationship. In the PFI context, the higher returns could come from the passing back of risk. The scope for suppliers to do this will be increased if boundedly rational buyers have been unable to sign complete contracts.

The nature of transactions under the framework

On some occasions, the problems of bounded rationality and opportunism can be solved by the use of market discipline and/or contractual safeguards. However, on other occasions such mechanisms will be less effective. The key concept here is asset specificity. Asset specificity refers to those investments made in a relationship (human, physical or site) that are specific to the relationship in question and cannot easily be transferred to any other or future relationship with a different buyer or supplier (Williamson 1985). The effect of asset specificity is that it provides a barrier to buyers or suppliers exiting a relationship, that is, it leads to lock-in. This is because to do so would mean writing off the specific investments that have been made. This will be especially problematic for the buyer, that is, there will be a situation of asymmetric lock-in, if the buyer has made the majority of the required specific investments. Where this is the case, the buyer will find that while its own exit is constrained, that of the supplier is not. Under such circumstances there will be a shift in the balance of power towards the supplier; a shift that will provide the supplier with the ability to engage in the relationship on its own terms.

What can also lead to asymmetric lock-in are the costs of the adjustment process known as switch. These are defined as the costs of transferring

responsibility for supply from one third-party to another and include the costs of: (1) searching the market again; (2) of a recontracting exercise; (3) of bringing the new supplier up to a satisfactory performance level (difficult if much of the knowledge has passed to the original supplier); and (4) costs incurred during the transitional process. These costs, again, provide a disincentive to changing suppliers and, again, if the buyer is faced with greater switching costs than the supplier, there will be a shift in the balance of power towards the supplier.

The problems of asymmetric lock-in are even more acute where the transaction in question is characterized by a high degree of uncertainty. Uncertainty exists when: (a) there are many known alternative outcomes; or (b) when there are known to be many unimaginable possibilities. Many PFI contracts contain both types of uncertainty. As a result, in many PFI projects, there have been renegotiations and contract extensions a number of years into the contract. This is not a problem in itself; flexible and/or incomplete contracting are part and parcel of complex contracting arrangements. However, the required renegotiations are clearly going to be more difficult for a buying organization to undertake if they have become asymmetrically locked-in to, and dependent on, a supplier.

Managerial capacities and constraints under the framework

Thus far, the framework has been developed using the assumptions and concepts developed by TCE. However, while both the author and TCE identify asset specificity and uncertainty as a potential problem for obtaining vfm, particularly because of the behavioural context of opportunism, TCE is far more optimistic that asymmetric lock-in can ultimately be avoided. The reason for this is the further behavioural assumption TCE puts forward: 'feasible foresight' (Williamson 1990). TCE argues that bounded rationality is not the same as myopia. As a result, it feels able to argue that in addition to possessing bounded rationality, managers possess feasible foresight.

This is crucial as it means that managers are capable of what Williamson calls 'farsighted contracting' (Williamson 1990). He comments: 'Economic actors have the ability to look ahead, discern problems and prospects, and factor these back into the organisational/contractual design' (*ibid.*, p. 226). So while they will not be able to develop complete contracts, due to bounded rationality, feasible foresight allows them to develop broad contractual safeguards. So, where the potential problem is asset specificity, it is argued that managers will be able to anticipate the risk and ensure that the asset-specific investments are shared or, where that is not practical, ensure that what are known as 'hostages' (compensatory financial arrangements) are posted (Williamson 1985). Such actions lead to contractual balance being achieved (interdependence) and asymmetric lock-in being avoided because both parties then have an equal stake in the relationship continuing. This condition of interdependence will then facilitate risk-sharing 'partnership'

behaviour throughout the course of the contract and lead to an efficient outcome.

A study of the official PFI guidance to public managers reveals that it is this logic that has very much underpinned the expectation that 'partnerships' will be formed under the PFI (Office of Government Commerce 2002; Public Accounts Committee 2003a). However, while TCE presents an elegant model, there are serious problems with it. In particular, there are five main obstacles to asymmetric lock-in being avoided in the manner outlined by TCE that will often, although not always, be present in a contractual situation.

The nature of pre-contractual power relations

To start off with, the power relation at the pre-contractual stage could be skewed towards one party (Campbell and Cunningham 1983; Ramsay 1994; Cox *et al.* 2002). Here, power is defined as the ability of A to make B act in a manner that it would not otherwise have done (Lukes 1974) and understood in terms of dependence relations (Emerson 1962). If, at the initial bidding stage, the buyer is in a weak position it may not be able to persuade the supplier to commit to a balancing of the contract in the manner outlined by Williamson. The supplier will usually wish to perpetuate its dominance. The possession or otherwise of feasible foresight, therefore, will be, to a large extent, irrelevant to the contractual outcome.

The relative commercial resources of the two parties to the transaction

Secondly, contrary to Williamson's assumption (1995), the purchasing function of the buying organization will often possess inferior resources, in terms of capabilities and capacities, to the sales team of the supplier and be unable to exercise feasible foresight. This can lead to the purchasing organization signing an inappropriate contract – through sheer pressure of time as much as anything else. Many bodies, including the NAO (2000a, b, 2002a), the Industrial Society (2000), Sussex (2002) and the Public Accounts Committee (2003a) have expressed concerns about the capabilities and capacities of the public sector purchasing and contracting functions dealing with PFI projects. This aspect of the framework is crucial since the whole case for the PFI rests on the ability of the public sector to effectively undertake extremely complex procurements.

The relative 'politicization' of decision making within the two parties to the transaction

Thirdly, Williamson's concept of feasible foresight does not take into account the possibility that there might be different agendas within the customer organization that lead to actions that are unfavourable to effective contracting. It is stretching credulity to expect all members of an organization to both possess the contracting foresight that Williamson deems necessary to avoid post-contractual dependency as well as to prioritize such

issues above the other concerns they might hold. According to Child (1972), managers tend to see organizational issues through the prism of their own functional sub-culture. In many functional sub-cultures, issues of contracting hardly figure at all. It is unlikely, therefore, that contractual foresight will in the first place exist and in the second place be prioritized in all parts of an organization. Yet as studies of organizational decision making have routinely shown, it is not necessarily those that are best qualified to make (or influence) decisions who do so. Rather, decision making is heavily influenced by intra-organizational power (Hickson *et al.* 1971).

The relative salience of the transaction to the two parties

A fourth factor that can lead to a post-contractual balance that favours the supplier is the relative salience of the transaction to the two parties. When the importance of a transaction to a buyer is greater than it is to its supplier, the problem of asymmetric lock-in is once again a possibility. This is particularly relevant to the public sector. The public sector has statutory duties that it must fulfil and key services it must continue to provide. It is, therefore, vulnerable to a supplier recognizing this and negotiating hard when problems or changes in the nature of the public body's requirements require a change in the nature of the product or service provision.

The relative switching costs faced by the two parties to the transaction

Under the transaction cost economist (TCE) framework, feasible foresight enables managers to address the risks arising out of asset specificity. Managers are able to look forward, recognize the need for asset-specific investments and ensure that they are, as was explained earlier, shared or compensated for by the posting of 'hostages'. However, it is not obvious how such 'switching costs' can be 'managed'. In any contractual situation there will be a cost attached to the process of shifting the organization's resources from one contract to another. On some occasions they will be high, on others low. On some occasions when they are high they will fall on both parties equally, on others they will affect one party more than the other. In the latter situation, there will be a shift in the balance of power between the two parties, yet it is not obvious what kind of 'management action' could fully guard against such a shift.

Alternative scenarios under the framework

A summary of the risk transfer model is shown in Figure 1, above. It indicates a number of scenarios for creating a contract. First, where asset specificity and switching costs are negligible, there is no risk of lock-in. Here, the risk of suppliers not honouring the contractual agreement can be managed by threatening a return to the market as well as effective monitoring (to protect against moral hazard). Some, although relatively few, PFIs will accord to this scenario (waste management and catering PFIs exist, for example, that are of low asset specificity). However, there will be other PFI scenarios

where asset specificity and switching costs are significant. Here, as we saw earlier, there are a number of obstacles that potentially stand in the way of the avoidance of asymmetric lock-in.

Thus far, we have only considered how these obstacles might work against the buyer. In fact, the effect of these obstacles can work both ways and cause an outcome of asymmetric lock-in favouring the buyer. If the buyer is in a dominant position pre-contractually; if the buyer possesses superior managerial resources; if the supplier's contracting is affected by internal politics; if the supplier values the transaction to a greater extent than the buyer; and if the relative switching costs favour the buyer, then the buyer may be able to benefit from the supplier being locked-in post-contractually. The difference between this author and TCE is that, as this paper makes clear, the possibility of power asymmetries is accepted. Further, these asymmetries can favour either party.

Finally, it is important to note that, although five potential obstacles have been identified, not all of these need to be present in a contractual situation in order for the prospect of contractual balance to be affected. Because of this, contracts that involve significant levels of asset specificity, switching costs and uncertainty are extremely difficult to manage. There is no question, then, that, if nothing else, the PFI is an extremely ambitious policy.

The argument of contingent renewal (Bowles and Gintis 1998) presents a potential retort to this framework. This argument states that a supplier's willingness to exploit asymmetric lock-in will be tempered by its desire to obtain future business from the customer. This is a powerful argument and one that needs to be addressed. The author's response to this is that on some occasions contingent renewal will indeed be effective in tempering supplier behaviour *vis-à-vis* lock-in. But not always. It will depend on three factors, as outlined below.

First, the ability of the buying organization to offer significant future business within a reasonable time period cannot be assumed. Secondly, there is the issue of homogenous market behaviour. In markets where asset specificity is a common feature, there is often an element of all suppliers pursuing similar pricing policies, that is, either lock-in or unbundled pricing. Any threat of a future move to other suppliers who would act differently, therefore, can lack credibility. Thirdly, an assumption behind the argument of contingent renewal is that managers will act rationally in accordance with the long-term interests of their firm. It is thus argued that managers working for suppliers will not risk a long-term association with a customer for the sake of a short-term gain. This, again, cannot be assumed, not least because managers have a tendency to move positions/organizations on a regular basis. This seems to be particularly the case in Anglo-Saxon countries, thus raising the possibility of a principal-agent problem (Macho-Stadler and Perex-Castrillo 2001). Overall, therefore, the present author does not reject the principle of contingent renewal. Rather, it is a circumstance that is simply added to the risk transfer framework (see Figure 1, above). It is therefore

a further variable (and an unpredictable one at that, because of the presence of the principal-agent problem) affecting the ability of buying organizations to avoid the consequences of asymmetric lock-in.

Issues regarding PFI contract terms

Before we proceed to the case evidence, it is important to comment on how the framework sits in relation to the legal contracts used under the PFI (or any other contracting situation). What is being argued here is that there is a difference between the legal right to exit a contract or impose penalties and the practical ability to do so. For example, the UK Office of Government Commerce (OGC) has generated an extensive document that provides recommendations for contractual design under the PFI (Office of Government Commerce 2002). It states that PFI contracts should contain early termination clauses, protections against late service commencement, information warranties, mechanisms for penalizing poor performance, and mechanisms for dealing with changes in the required service. However, under conditions of asymmetric lock-in, these legal rights can, to a large extent, be academic since the aforementioned 'wider concern of nurturing a partnership' will predominate.

RISK TRANSFER, THE PFI AND ASYMMETRIC POST-CONTRACTUAL LOCK-IN: CASE EVIDENCE

Having outlined the framework, it is now necessary to present empirical case material in support of it. The argument being advanced in this paper is that it is not a question of *whether* the PFI can deliver vfm, but *when*. Therefore, the case material needs to provide an example of both success and failure (one of each is all that space permits) and convince the reader that the reasons for the different outcomes are explained by the framework. The successful case that has been chosen is the PFI for the business operations for National Savings and Investments; the unsuccessful case is the PFI for IT systems in magistrates courts. The two cases have been drawn from publicly available data. These data were then verified with various relevant people. Those interviewed, however, due to the sensitive nature of the material, have requested that they themselves remain anonymous.

The contract between National Savings and Investments and Siemens Business Services

The contract between National Savings and Investments (NS) and Siemens Business Services (SBS) covers all the operations required to process transactions and provide a customer service to NS's 30 million customers. NS offers a range of savings products, including Premium Bonds, Savings Certificates and Investment Deposits. In 2000, it had a 12 per cent share of the UK retail savings market. Historically, the operations of NS had been undertaken by public servants (NAO 2000c). However, by the mid-1990s, the government took the view that the operational efficiency of the in-house team was below

the standards of the industry at large and that this performance lag was putting the competitive position of NS at risk. As a result, in 1997, NS invited tenders from private sector providers to take over full responsibility for the business operations. The story of the contract between NS and SBS provides an example of the PFI delivering vfm for the taxpayer. It is argued that this successful outcome can be explained in terms of the risk transfer framework developed in this paper.

NS's business operation prior to this initiative consisted of three main parts. First, a core staff of about 130 were responsible for the design, management and marketing of its current and future financial products. Second, a large body of staff, about 4000, were responsible for the processing of transactions and the delivery of customer service. Finally, the existing operation had an IT system (NAO 2000c). The outsourcing was to concern the latter two parts of the operation, both containing significant asset-specific investments, both physical and human, and characterized by a significant degree of uncertainty. NS recognized the risks of its outsourcing policy and started its management of that risk with the initial competition.

The first factor that led to the success of the procurement was the existence of, and then the management of, considerable competition at the pre-contractual stage. NS placed an advertisement in the Official Journal and 90 companies responded of which NS chose four to provide further information. NS then decided that it would take two of those suppliers to the final bidding stage: EDS and SBS. What has happened in many PFIs is that there has been contract drift after the preferred bidder has been chosen (Public Accounts Committee 2003a). This was something that the NS team consciously acted to avoid by keeping two parties in the frame until it had negotiated a draft contract with both – that is, they took the procurement to a very late stage before choosing a preferred bidder. This maintenance of competitive pressure allowed NS to negotiate balanced draft contracts with the two parties. Having established these, NS chose SBS as the preferred bidder.

NS's contract with SBS shows the importance of understanding the difference between the content of a risk-sharing agreement with a supplier and the vehicle that carries that content. NS used the pre-contractual competitive tension it maintained to negotiate balance in both respects. The content of the agreement included: (1) an arrangement concerning the introduction of new products, whereby the work would be opened up to competition if SBS's performance was sub-standard; (2) an arrangement whereby NS shared in any excess profits made by SBS, but did not take responsibility for any losses; (3) an arrangement whereby SBS was responsible for operational errors and staff fraud; (4) 42 Key Performance Indicators (KPIs) across eight areas of operational service; (5) a clear termination schema; (6) formal change processes in order to deal with uncertainty; (7) an arrangement whereby NS benefits from SBS's success in winning third party contracts; and, finally (8) an arrangement whereby SBS is obligated to assist with the transfer of the operation to another supplier should it not be reselected at

contract renewal – an attempt to mitigate as much as possible the problem of the costs of switch (NAO 2000c).

However, NS realized that these clauses would be academic if there was no vehicle on which they could be carried. This vehicle consists of an appropriate incentive structure. NS was making a significant step in outsourcing the whole of its business operations. The costs of switching to another supplier would be significant, notwithstanding the agreement with SBS over the transition. NS was also vulnerable in terms of the transactional salience of the contract. The operations were its whole business and that business concerned more than 50 per cent of the population. A crucial part of the contract, therefore, was the agreement that SBS's parent company, Siemens AG, guarantee SBS's obligations under the contract. The NAO reported that Siemens's liability was set at up to £250 million (NAO 2003a). By balancing out its own vulnerabilities in the relationship, this part of the contract provided the incentive structure that allowed NS to enforce the content of the risk-sharing agreement. The vulnerabilities of NS, in terms of the transactional salience of the contract and the potentially significant switching costs of moving to another supplier, were, to a large extent, neutralized by the £250 million commitment provided by the supplier's parent company. As the NAO reported, the liability provision 'places the onus on SBS to improve [should it find itself in a] loss-making position', rather than being able to 'hold-up' service provision at the first signs of trouble (NAO 2003a, p. 27).

This kind of parent company guarantee has been absent from many large-scale government contracts (PFI or otherwise) where the natural balance of sunk and switching costs has favoured the supplier. The absence has often been a key factor behind the frequent failure to achieve contractual balance. A recent example was the contract between the Ministry of Defence (MOD) and Devonport Management Ltd (DML), for the construction of the new nuclear facilities at the Devonport shipyard. The maximum price to be paid by the MOD under the original contractual agreement was £650 million. However, there was an expectation that it should cost the MOD much less than that – £576 million. Unfortunately, by late 2002, the estimated cost had risen to £933 million. There was a dispute between the two parties over who was liable for the cost overrun. However, to a large extent, this dispute was academic as it was reported that one of the main reasons why the MOD eventually agreed to pay for most of the increase was that liability for the increase would probably have been too much for DML to bear. DML's assets in 2002 were only valued at £60 million and its parent company guarantee was only £35 million (NAO 2002b).

We can see, therefore, that the sympathetic pre-contractual power situation enjoyed by NS was crucial to its being able to develop contractual balance. Also crucial was the fact that NS put together for the procurement a well-resourced and highly capable procurement and contracting team. The NAO reported that 'Senior National Savings management committed a large amount of time to the project... National Savings [also] benefited from

the input of the Treasury ... [and] National Savings appointed advisors in good time following competitions in which success depended on the quality of advice on offer' (NAO 2000c, pp. 37–9).

This level of commitment and resourcing was said to have been maintained after the contract: 'To monitor SBS's reporting of performance satisfactorily, National Savings has increased the resources it devotes to these tasks and plans a further small increase' (NAO 2000c, p32). The procurement and contracting team also put together a comprehensive contingency plan, with multiple scenarios accounted for (NAO 2003a). Finally, it is clear that the NS team recognized the importance of having sufficient time to negotiate effectively (NAO 2000c). If time is your 'enemy' in a negotiation you are likely to end up making concessions in order to complete the deal within your time scale. Overall, it is clear that NS went into this negotiation with a team that was highly competent and well resourced. This allowed NS to make the most of the sympathetic pre-contractual power situation.

The final of the five potential obstacles to contractual balance identified by the framework concerns the political nature of organizational decision making. Again, NS seems to have successfully managed this potential risk factor. There is evidence from the details of the case – for example, the time given for effective negotiation – that the leading protagonists within NS were in accordance about both the objectives of their organization and how those objectives should be achieved. This accord provided a focus to its contract management that facilitated the development of a balanced contract with SBS (NAO 2000c).

The outcome of the contract has, thus far, been highly satisfactory, both in terms of cost and operational performance. The NAO reports that NS has 'added value' to the taxpayer, £176 million in 2001–2002 with a further £220 million expected in 2002–2003 (NAO 2003a). Furthermore, the benchmarking of its operational services, such as its call centres and automated processes, against similar 'leading edge' organizations, has shown it to compare favourably (NAO 2003a). As an example of this, in terms of customer service, NS, in partnership with SBS, has reduced response times down from seven to a more competitive three days, without sacrificing accuracy (NAO 2003a). Not that there have not been tensions between the two parties. It is reported that SBS has yet to make a profit on the contract, although it expects to do so before its end. This and a change in SBS management caused a period of 'arm's-length' management (NAO 2003a).

Despite these tensions, the contract between NS and SBS provides an example of how risk transfer can be achieved in complex contractual environments. NS are well placed to manage their future requirements for business services. At the same time, it also shows how contingent the circumstances are that permit such an achievement: (1) the pre-contractual power situation favoured NS; (2) it was able to put together a capable and well-resourced team; (3) there were no major internal political tensions that affected its contractual focus; and (4) its vulnerabilities in terms of transac-

tional salience and switching costs were balanced by the liability payment that NS managed to negotiate from its strong pre-contractual position. The presence of these circumstances are not guaranteed, however; indeed, in the case that follows they were absent.

The contract between the Lord Chancellor's Department and ICL

The NS/SBS contract discussed above showed how, under certain contractual circumstances, PFIs can provide good vfm for the taxpayer. This case, however, emphasizes that those circumstances are not always present. The case now examined is the contract for the magistrates' courts national IT system – the so-called 'Libra project'. For decades, UK magistrates' courts suffered from a patchwork of legacy IT systems. This multiplicity of systems had led to difficulties in the exchange of information between the courts themselves and between the courts and other relevant agencies. In the early 1990s, the UK government decided that a national IT strategy was necessary. The first attempt to implement this strategy by the Lord Chancellor's Department (LCD) (now known as the Department for Constitutional Affairs) collapsed in 1995 when its contract with Price Waterhouse terminated. In 1996, the LCD decided to try again, opting to utilize the PFI route (NAO 2003b).

The specification for the project consisted of two main parts: the infrastructure and the core application. The core application was to be a single, national application that would support the courts' entire workload. It was said that it would allow the management of case files, permit effective accounting and general administration, and provide direct links with the systems of the other criminal justice agencies that the courts needed to have contact with. The application was to replace all of the courts' current legacy systems (NAO 2003b). The project was clearly a highly ambitious and complex challenge that would require the making of considerable asset-specific investments. By definition, it also involved a great deal of uncertainty. These risks were to be managed, as ever under the PFI, through the development of a balanced, risk-sharing partnership with a private sector supplier. However, the relationship proved to be anything but balanced and led to an extremely poor vfm outcome.

The problems with the project started with the initial procurement. As we have discussed, a key factor in a buying organization being able to develop a balanced partnership with a supplier is the existence of a sympathetic pre-contractual power situation. With the Libra project, the LCD found it extremely difficult to hold a meaningful pre-contractual competition and acquire any semblance of bargaining power. Initially, there were three bidders: ICL, EDS and TRW/Bull. However, TRW/Bull dropped out of the competition shortly after it had been short-listed and, at the final bid stage, EDS followed suit and also withdrew from the competition. This led to ICL being the only remaining bidder (NAO 2003b).

Despite this, the LCD decided to go ahead with the procurement and appointed ICL as the preferred bidder in July 1998. It was argued by the LCD that ICL seemed to offer the prospect of a fruitful relationship despite the lack of competition (Public Accounts Committee 2003b). ICL's initial bid had come in at £146 million for a 10.5-year contract and LCD hoped to sign a contract on that basis in October 1998. Unfortunately for the LCD, before that happened ICL informed it that it could not adhere to its original bid price. The two parties eventually agreed a price of £184 million. The reasons given by the LCD for agreeing to the increased price show the weakness of its pre-contractual bargaining position. The NAO reported that the LCD believed that 'starting the procurement process again was too high a risk as the response to the original procurement had been limited' (NAO 2003b, p. 15).

So there was evidence from the pre-contractual negotiations that the adverse power conditions caused the LCD difficulties in negotiating a balanced partnership with ICL. This was confirmed very shortly into the contract. In October 1999, less than a year after the contract had been signed, ICL formally requested that the two parties renegotiate the contract as its cash flow forecasts showed a £39 million deficit over the life of the deal. ICL stated that if the shortfall was not addressed in a renegotiation it would walk away from the project. Furthermore, it demanded that the renegotiations be completed by March 2000, as it did not want to have to declare a loss in its 1999–2000 financial accounts (NAO 2003b). According to the LCD's calculations, ICL's threat was a credible one. ICL claimed that it was facing a loss of £39 million from continuing with the project. Yet the maximum liability they faced under the contract at that stage was just £10 million, something that the Office of Government Commerce was reported to have been unhappy about (Public Accounts Committee 2003c) and a stark contrast to the figure NS was able to negotiate with SBS. ICL was in a position, therefore, where it could credibly 'hold-up' the contract until it got what it wanted from the renegotiations.

This imbalance in the contract was also contributed to by a clear asymmetry in the transactional salience of the project to the two parties. ICL had already signalled that it was perfectly happy to walk away from the contract. Yet the LCD is reported to have not wanted the relationship to end because 'ICL's withdrawal would have forced the Department to find another supplier and this would probably have resulted in substantial delay' (NAO 2003b, p. 16). This was a problem since the LCD placed a high value on having the new national system in place as quickly as possible. Part of the reason for this was the current state of its existing legacy systems. The NAO reported: '[A termination would mean that] the roll-out of the infrastructure... would stop and [w]ould not be resumed until a new supplier had been procured, which might take up to 15 months.... Given that two of the existing systems were frail and could experience serious support problems, the Department considered it essential to have a robust,

alternative system available as soon as possible' (NAO 2003b, p. 21). In his response to the Public Accounts Committee investigation, the LCD's Permanent Secretary, Sir Hayden Phillips, said that the decision to continue with ICL was 'the least worst option' (Public Accounts Committee 2003b).

Another factor affecting the transactional salience of the contract to the LCD was its history of implementing IT systems. A further failed attempt at procuring a national system, after the Price Waterhouse termination, would have been politically embarrassing for the LCD, a reason not to be overlooked. Finally, the NAO also reported that the LCD did not wish to incur the 'associated costs' of switching suppliers, another factor affecting contractual balance that featured in the framework (NAO 2003b; Public Accounts Committee 2003b).

The outcome was that the LCD agreed to a renegotiation and in May 2000 announced an extended contract (from 10 to 14 years) priced at £319 million. It was argued, however, that most of the £135 million cost increase was accounted for by the term extension. (NAO 2003b). This was not the end of the saga, though. In April 2001, less than a year after the last settlement, ICL came back to the LCD and argued that it still faced financial problems, notwithstanding the renegotiation. This time it argued that it faced a loss of £200 million if it saw out the 14 years of the contract. It again threatened to walk away from the contract and again imposed deadlines on the LCD: a legally binding commitment to renegotiate by September 2001 and a requirement to agree a new contract by January 2002. Again, these dates accorded to ICL's accounting periods (NAO 2003b), again reflecting the imbalance in the relationship.

Initial discussions between the two parties led to the agreement of a Memorandum of Understanding in October 2001. This holding arrangement set out the basis for the ensuing negotiation. Under the memorandum, ICL put forward a price of £283 million for an 8-year contract, something which, while not ideal, the LCD felt it could potentially accept under the circumstances. However, in February 2002, ICL came back yet again with a different price, this time £400 million, for 'the enhanced infrastructure and full core application' (NAO 2003b, p. 19). This time the LCD refused to accede to ICL's demands and started to devise an alternative plan. However, again, its options were constrained by the huge switching costs it faced, combined with the importance it attached to delivering the national system.

The result was a compromise. The LCD is now contracting with three suppliers. ICL's involvement has been restricted to providing the infrastructure, for which it will receive £232 million. Despite its contribution to the problems with the project, ICL has still been allowed to earn a healthy 7 per cent profit margin, although it claims that this profit margin is offset by previous write-offs (Public Accounts Committee 2003b). The core application, meanwhile, is now being provided by STL, for a further £79 million. The LCD is also contracting with a systems integrator. When all of the other costs are added, the project comes in at £390 million for an 8.5-year contract. The

original contract signed in 1998 (after the first ICL renegotiation from £146 million) came in at £194 million for a 10.5-year contract (NAO 2003b).

In this project, the LCD faced significant structural problems that made the creation of a balanced partnership all but impossible. Whether ICL ever sought a balanced partnership or simply acted opportunistically is left as an open question. Any suggestion of opportunism was, not surprisingly, denied by the company (Public Accounts Committee 2003b). Given the existence of such problems, even a highly competent procurement team might have struggled to obtain vfm. There is evidence, however, that the LCD procurement team could not be described as highly competent. For example, there should have been a greater investigation of ICL's financial model for the project at the initial negotiation stage (NAO 2003b; Public Accounts Committee 2003b). ICL's figures were hardly looked at by the LCD. The fact that the LCD appointed a new project director in 2001 also suggests shortcomings (NAO 2003b).

Indeed, Sir Hayden Phillips made a comment to the Public Accounts Committee that has relevance not just for this PFI contract, but the PFI and government contracting in general. He said that 'the level of professional and commercial expertise on the part of government clients and those people advising people in my position was much lower than was desirable to handle contracts of this nature where so much risk is being transferred. It has been a major concern of the Office of Government Commerce, and its Supervisory Board of which I am a member, to try to make sure that that position is progressively improved so that we do get more intelligent clients than we have done' (Public Accounts Committee 2003b). This is quite an admission from a member of the UK government's procurement advisory body. Phillips is essentially saying that, at the current time, the UK government does not have in its departments, on many occasions, the capabilities required to handle the type of complex contracts that are a feature of the PFI. Yet the success of the PFI relies heavily on the existence of such capabilities, as we saw from the theoretical discussion earlier. Finally, there was also evidence of political decision making. The initial decision to go ahead with the project, despite there being only one bidder, gives the impression of being a decision driven by political imperatives, rather than one based on sound procurement and contracting.

By any standards, the story of the Libra project is a sorry one. The NAO is in no doubt: 'The cost of Libra is now considerably higher than in the original contract' (NAO 2003b). What is most striking about this case, however, is that it is abundantly clear that the private sector supplier was not willing to accept any financial risk if it did not have to. The idea of the relationship being a 'public-private partnership' where risk was transferred was left looking extremely empty, a point emphasized by the Public Accounts Committee chairman, Edward Leigh (Public Accounts Committee 2003b). ICL appeared to act as if it believed it had a natural right to a profit margin, whatever the standard of its performance. And, as we have seen, the

circumstances of the contract did indeed mean that the supplier did not have to accept the full brunt of the project risk.

Indeed, the Chief Executive of Fujitsu Services (the name ICL is no longer used by the Fujitsu company), Richard Christou, made an interesting comment about risk transfer under the PFI: 'If, in the end, many IT suppliers suffer these sorts of things then the supply of IT contracts for government will no longer exist' (Public Accounts Committee 2003b). This could be interpreted as a private sector firm saying, 'We expect the PFI to provide us with guaranteed profitability. If it does not, we will not participate'.

The LCD was in a poor position on all fronts in the case of this contract. It was in a weak pre-contractual power position, the competence of its procurement team was questionable, it faced problems with asymmetric switching costs and it was clear that there was a huge asymmetry in the extent to which the two parties valued the contract. Furthermore, the decision to continue with the project when there was only one bidder seemed to be more driven by the politics of the situation than the economics. In the case of this project, all of the contractual circumstances required in order for a balanced contract to be developed were absent. The outcome was predictable.

CONCLUSION

The advice on the PFI provided to public managers shows a remarkable resemblance to the strictures of TCE (transaction cost economists) (Office of Government Commerce 2002; Public Accounts Committee 2003a). This is particularly so with respect to the development of balanced contractual partnerships in the cause of managing asset specificity and uncertainty. However, the argument advanced in this article suggests that balance in such contractual situations is not as easy to secure as TCE would have it. There are a range of factors that can affect contractual balance and cause asymmetric lock-in: pre-contractual power relations, the resources and capabilities of the two parties, the commercial focus on optimal contracting, transactional salience and switching costs. Where these factors favour the supplier, the buyer is likely to receive poor vfm.

The impact of these factors on vfm was clearly seen in the two case studies. In the case of NS and SBS, the contractual circumstances and buyer capabilities meant that good vfm could be achieved by NS. In the case of the LCD and ICL, the contractual circumstances and buyer shortcomings led to a disastrous outcome for the LCD. So what are the implications of the theory and evidence presented in this article to the PFI in general?

First, they allow the reaffirmation of the view that there is nothing inherent about the PFI that means that it cannot deliver vfm for the taxpayer. It is a question of when not whether (although vfm outcomes will obviously also be affected by the additional costs associated with the PFI referred to in the literature review above). If the transaction is of low asset specificity (for example, the PFIs for catering and waste management seen in recent years)

or if the contractual conditions are sympathetic to risk transfer, as in the NS/SBS case, then there will be a chance that the PFI will be the most cost-effective procurement route. However, where the transaction involves significant asset specificity, switching costs and uncertainty, and the contractual conditions are unsympathetic to risk transfer, as in the LCD/ICL case, then a less propitious outcome will usually result.

Second, because contractual balance is, in reality, more difficult to achieve than TCE and PFI supporters might lead us to believe, it is important to question the tendency of the PFI to increase the asset specificity, switching costs and uncertainty of contracts on many occasions. In an attempt to take advantage of (assumed) superior private sector management skills and in order for the private sector supplier to re-coup its significant up-front investment, PFI contracts often involve the provision of a 'bundle' of products and/or services and run for many years, often decades. This often leads to very high levels of asset specificity, switching costs and uncertainty.

It may be that, under certain contractual circumstances, for example, where adverse power relations exist, better outcomes would be achieved if product/service provision was broken into smaller elements, provided by different suppliers (perhaps including an in-house team) and delivered under shorter contracts. Now this would probably, although not necessarily (trying to monitor and control dominant suppliers is an expensive enterprise), lead to higher transaction costs over the contract period. But, unlike TCE, the author is not here merely concerned with transaction costs affecting efficiency. There is also the issue of leverage costs that arise due to power asymmetries, as the LCD/ICL contract vividly illustrates. The first priority of any buying organization is to have control over its supplier. This is often not the case under the PFI and a willingness to try other options will be required.

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