

DEFENSE

Informal governance of defense procurement contracts

By Jean-Michel Oudot

Contracts resort to formal and informal devices to coordinate parties. The relative roles of them are emphasized to favor a common understanding and appreciation of *ex post* contracts governance. An illustration is provided by French procurement contracts.

Contracts determine the conditions of trade of goods or services. Beyond objectives pursued in terms of prices, expected delays and quality, contracts also participate in the coordination of parties by stipulating their rights and duties and management procedures (Carson, Madhok and Wu 2006). These specifications may be formal or informal. This article proposes to analyze the role of contracts in the coordination of parties by investigating the relative influence of formal versus informal contract terms to coordinate parties after the initial agreement is signed. The defense procurement sector France is mobilized as an illustration case.

Defense as a network industry

Defense procurement contracts are signed by the Department of Defense and contractors, most of them are private. Whereas the latter develops, produces and maintains in operation capability defense systems, the former pays for equipment delivered. Once produced, systems are transferred to armed forces for use. This sector can be regarded as a network industry for two reasons.

First, the production of defense systems implies the combination and interconnection of many different types of equipment (for instance helicopters are composed of structures in which engines, electronic systems, armaments and security

devices are interacting). Interdependencies of different production and transmission points of information and goods cause spillover effects: any delay or reduction in quality of those types of equipment leads to decreases in performances of the system as a whole in terms of time, costs and/or quality, which characterize networks.

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Second, once realized, defense systems are spread over territory and interconnected to other defense systems to create a consistent defense network. Any failure of one component creates weaknesses of the security system as a whole, which is also a feature of networks.

A study on defense contracts

To understand the role of contracts in the coordination of parties, I have conducted a research based on the precise analysis of 48 procurement contracts signed by the French Department of Defense and 18 European contractors between 1994 and 2005. The mean price of these medium term contracts is €135 million. In gathering the data and running their analysis, I was concerned with the development of a micro economic study to understand the

conditions for implementing the terms of procurement contracts.

Here, I suggest that defense procurement contracts can be regarded as partly subject to informal decision-making. Informal terms refer to implementation conditions of agreements not explicitly formalized in contracts but enforced *ex post* by transaction parties. The analysis of risk allocation decisions in French defense procurement contracts revealed such informal practices. Whereas formal terms allocate all cost-overruns to contractors whatever the *ex post* contingencies might be, renegotiations occurred *ex post* causing a transfer of cost-overruns to the department of defense, transforming cost-overruns into price-overruns. Motivations for such changes turned out as to be justified by informal agreements and *not* by formal ones (Oudot 2006).

Responsibility and hazard equilibration principles

In that perspective, two principles apply in the sector analyzed: the responsibility principle and the hazard equilibration principle. The former refers to situations in which parties are able to determine their relative responsibilities and stipulates that financial consequences of adverse events are transferred to the partner responsible for their sources. The latter corresponds to

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cases in which parties cannot identify their relative responsibilities (because of information incompleteness, or information asymmetry, or bounded rationality associated to complexity) and leads to the fifty-fifty sharing of cost-overruns.

Resorting to such informal agreements can be explained by several factors: the lack of contractual abilities to govern complex transactions (Argyres and Mayer 2007); the wish to favor adaptation capabilities through avoiding to be locked by initial formal contractual terms and through bypassing regulatory constraints; the transaction cost minimization objective (that is avoiding writing costs of agreements); the confidence of parties in equitable conditions of trade; and the wish to avoid signaling to the Parliament potential price-overruns in contracts. The choice of informal terms of trade is thus predominantly interpreted as a deliberate decision, although some constraints also exist in that perspective.

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As a consequence of the predominance of informal decisions rules to coordinate parties *ex post*, the role of formal terms may be questioned. On the one hand, formal terms seem to serve as a general coordination guideline to be completed over time and from which parties can substantially depart from in various and precise circumstances. On the other hand, formal terms are also used as a way of validating informal decisions to comply with regulation.

It follows that formal and informal agreements are complementary, rather than substitute, to govern transactions (Poppo and Zenger 2002).

Reputation and repetition

Informal agreements are enforced thanks to two complementary features. First, reputation effects constrain parties not to deviate much from initial terms of trade, for fear of not being considered as trustworthy. These reputation effects, which are strong in the defense sector (Kovacic 1991), should be associated to a second feature to favor the enforcement of informal agreements: the repetition of transactions. When parties interact frequently, business relationship is worthwhile when it creates incentives not to deviate from informal decision rules that would have been decided at early stages of agreements.

Both reputation and repetition of transactions make informal agreement sustainable and self-enforced. When one party violates the terms of trade, the only recourse of the other is to terminate the agreement. In the French defense procurement sector, parties solve their disagreements without resorting to third agents: transaction parties renegotiate among them. Suing is not an enforcement strategy at all, as opposed to the case detailed by Spiller and Liao (2006).

The informal nature of contracts has two main consequences. From an analytical perspective, the predominance of informal terms in the coordination of parties emphasizes the need to go beyond the analysis of formal contract terms to understand and explain contractual choices. As far as the public control policy is concerned, audit authorities

are expected to undertake micro analytic studies to appreciate the relevancy of decisions taken *ex post* by transaction parties, especially those causing price increases. Otherwise, public authorities lack crucial information and implicitly authorize public agencies to subsidize private companies.

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Jean-Michel Oudot, a member of the research center *Analyse théorique des organisations et des marchés*, is lecturer in economics at the University Paris I Pathéon-Sorbonne, Paris, France. Email: <oudot@univ-paris1.fr>