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AGENCY CONFLICTS IN THE FLEXIBILIZATION STATE STRATEGIES: THE CASE OF ECOURBIS

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SUMMARY

The necessity of the State to lead the development movements of the country, constantly investing in the improvement of the life conditions of the citizens, faces growing challenges brought by insufficient funds and the need for administrative flexibility to directly accomplish projects that promote this development. The solution found, since the spreading of the flexibility of the state owned company after the decade of the 80's in the scope of *New Public Management*, has as a premise the transfer to private partners the leadership in the implementation of projects previously executed by the State according to mechanisms based on contracting. The objective of the current research is to identify how agency problems are configured in the relationship between the State and private initiative, when the implementation of strategies for the flexibility of action of the state owned company. For the State, the contracting includes mainly the agency problems and the related costs, given the divergences between the planning horizon of the stakeholders, expected results, and the monitoring and control of execution. The chosen methodology is based on the case study of the partnership experience between the State and the private initiative contracted on the basis of the law of Public Concessions, the EcoUrbis Environment S.A., but that meets most of the characteristics of the contracts accomplished based on the model and the legislation for public-private partnerships in Brazil. The case analyzed allows the understanding of the process of building regulatory tools utilized by the State to deal with agency problems in the partnership projects with the private initiative, observing the structure of the tools as independent agencies, control of entry and exit to the market, regulation of the competition, questions about the value of the tariffs and incentive mechanisms, as well as monitoring contracts.

Key words: State; flexibility strategies; governance; public-private partnership

1. INTRODUCTION

The relevance of the State has the role to guarantee the quality of life of its citizens and promote social objectives and the development has been squeezed by the pressure to reduce spending, by the search for greater efficiency and, mainly, by the lower capacity for debt. In Brazil, the constricting pressures can be exemplified by the Resolution 78 of the Federal Senate, which is about the contingency of the Public Sector and its limitation of financial leveraging, and by the Complementary Law 101/2000 or the Law of Fiscal Responsibility (LFR), geared to the promotion of fiscal management responsibility and the balance of public budgets.

This, however, is not a local scene, certainly permeating the state action in the majority of countries following the approach of the reform movements of the public sector initiated in the Anglo-Saxon context in the decade of the 80's and that converged in a set of practices and organized definitions following a model of the so called *New Public Management*.

Consequently, the need of the State to lead the movements for development in the country, investing constantly in the betterment of the conditions of life of the citizens, faces the growing challenges brought by the insufficiency of resources and the necessity of flexible administration for the direct completion of projects that promote this development. The solution found, as a result of the flexibility of the state company propagated in the environment of the *New Public Management*, has as a premise the transfer of the private partnerships of leadership in the implementation of projects currently executed by the State according to mechanisms based on contracting.

For the State, this transfer represents gains in terms of efficiency and the increase in the capacity for action, besides allowing a greater focus on the social policies and typical activities of the State. For the private initiative, in turn, and its expectation to leverage the business and increase market share, the different models for the flexibility of the state company offer the opportunity to participate in investments in new sectors, traditionally operated by the State, utilizing installed competencies, enlarging scales and improving their earnings. However, this transfer creates, naturally, agency problems not experienced by the State when the situation as the implementation of the enterprises.

Besides these more traditional forms of flexibility of state company action based on the permission, authorization, conventions and consortia, one of the principal forms of the State to conduct this action is by so-called common concessions, known as authorization of services or public works of which the Law n. 8.987/95 – Law of concessions, when it does not involve cash considerations of the public partner to private partner. In this case, because of the issue of cash, the public-private partnerships (PPP) are not part of the list of concessions that are dealt with by the Law.

What differentiates these two models from the rest is, beyond the normative reference, the structure of the contracting for the operation. The formal relationship between the State and the private initiative materialized in the contract makes a difference not only in respect to the risks assumed by the parts but also the returns that each expects to receive in the business.

However, such business and formal relationships of the State with the private initiative can generate conflicts, once the management principles and practices adopted by the public sector are usually distinct from those adopted by the private business, an

example of the purchasing processes, evaluation of results, and management of real estate assets, among others. Other typical agency problems, based on divergent objectives, propensity for risk and planning horizon emerge in the relationships, and from which management can cause as much significant costs as conflicts in the agreement of objectives.

In this study we tried to analyze the occurrences of agency problems in these relationships of the State with private organizations and search models that contribute to the best effectiveness in the contracting process. Hence, the final objective can be described as how to identify the agency problems that arise when the State decides to make flexible its action in partnership with the private initiate to undertake investment projects. Having as a basis the reference of the Agency Theory, and taking as a principal reference the situation of the State and its relationship with the Brazilian business environment, we contextualize the issues arising from the flexibility strategies by analyzing a real application case of these strategies – the company EcoUrbis - for ways in which these problems are addressed and the weaknesses that may persist.

2. The current State: the fiscal problem, the increase in social demands and the strategies for flexibility

Historically, it is possible to observe the adaptation of the Law and the institutionalization of the political power to the new concrete realities. As an example, we see the transition of the bourgeois democracy to a social-democracy, from liberalism to interventionism and the Liberal State of the Social State. These changes were the results of the social and economic transformations that occurred during the period encompassing between the 19th and 20th century, including all the historic period of the different steps of the evolution of capitalism.

However, in order that one can experiment a Social and Democratic State of Law, it is necessary to make mass democracy compatible with a market economy. This is only possible when there are available means necessary to promote the principles of liberty and social justice, preserving the rights and fundamental guarantees. On the other hand, the public investments that provide basic services for society come up against one of the structural limits of a capitalist economy, since the resources available for the State originate from subtractions made from capital and earnings from employment, through the fiscal manner, both being the sources of resources with clear limits; in other words, one cannot obtain return on capital beyond certain margins without unbalancing a system based on private investment nor can one disproportionately increase the tax burden imposed on the taxpayer, under the penalty of provoking social discontent and a restriction on demand (CASTELLS, 1983).

In this scenario of structural limit of the capitalist economy, one imagines the possibility of a crisis of the Social and Democratic State of Law, because this one remains weakened to trigger public investments, even as compensatory mechanisms, which permit compatibility between mass democracy and a market economy.

In Brazil, one actually notices this limit and this crisis, once the policy of social well-being in the 1970`s until the beginning of the 1990's was being financed by the Public Administration through an inflationary policy, which, in reality, harmed the poorest population. For a long time, especially in the face of inertia of the organized civil

society and the Federal Government, this inflationary process was fed, creating a series of distortions in public administration (COUTINHO, 2004).

The administrative reforms, considered a set of measures geared toward the reduction of public expenses and the improvement of public management, starting noticeably with the privatizations and the revision of the Plano Real and more recently, with the approval of the Complementary Law 101 (or Law of Fiscal Responsibility), were initiatives taken by the federal government in this context.

Beginning in the 1980´s, governments of different countries started to face, to a greater or lesser degree, restrictions to their capacity of investment, either as a result of an increase in social spending and retirement funds, or as a need to establish fiscal discipline to address deficit and debt limits (BRITO & SILVEIRA, 2005). Thus, a process of spending limits was started that led to a restriction on the capacity of public financing for investments.

The service providing State became insufficient. (DI PIETRO, 2002), being replaced by the State as a repairing and stimulating agent, which assists and subsidizes the private initiative, be it through the democratization of Public Administration with citizen's participation in the decision-making and consulting organs, be it by a greater communication and integration between the public and the private in the accomplishment of the administrative activities of the State. Thus, one seeks a new relationship of balance between the size of the state and its mission, yielding greater efficacy as well as efficiency.

Over the years the State assumed numerous responsibilities in the socio-economic areas, incorporating both industrial and commercial services and diffusing the judicial boundaries and order between the public and private spaces. (DI PIETRO, 2002). More recently, the existence of a more restrictive context forced the adoption of new management forms of the state apparatus as well as considerations about the essentiality or responsibility for the activities implemented. The concept of specialization as a mechanism to promote efficiency led to a movement to mimic the practices and methods utilized in the private management, and to the search for references of more flexible and adaptable models, capable of addressing the new demands of the role of the state.

In general, the instruments for making the state action more flexible have been employed with the objective of alleviating the State from its numerous functions, increasing simultaneously the scope of action and efficiency in providing public services, besides influencing the private initiative in the performance of public interest activities.

Making the State more flexible involves more decentralization, simplifying acquisition procedures, an orientation toward less-process driven control procedures, and changes in the rigid way of practicing Public Administration. Various strategies or instruments can be utilized in this sense, such as privatizing, service permission or authorization, accords and consortia, and Public Concessions (simple) and PPP – Public Private Partnership. This study focuses on these two last models to consider the treatment of agency problems in these strategies, which will be treated in more depth.

Initially, one of the most widespread strategies occurred in delegating the implementation of public services to private companies, through concessions, bringing as an advantage the possibility for the State to provide essential public service, without the need to allocate public resources and without taking any enterprise risks. However, at the moment the State began to participate in the risks of the enterprise, the concession began

losing interest and new forms of decentralization were sought out (DI PIETRO, 2002). In the Brazilian case, according to article 175 of the Federal Constitution, the concession is only granted when services are provided to third parties (users) according to a commercial utilization, that is, if there is some possibility of revenue production favoring the concessionaire.

The need for other configurations that would enable the risk of the state to be reduced and a demand for its participation in the allocation of resources in actions not limited to its domain, led to the creation of the so-called Public-Private Partnership, or simply PPPs. A PPP is characterized as an administrative arrangement that materializes into a contract, whose purpose is to provide an economic infra-structure of the government's responsibility, utilizing managerial and financial elements of the business world in conjunction with the typical guarantees of the public sector, which, as a rule, defines the sectors of the economy where such partnerships are possible.

Created in Great Britain at the beginning of the 1990's, under the orientation of the labor party and the influence of Anthony Guiddens' ideas, known as the theoretician of "the third path", the PPPs are manifestations of a thought that valued a partnership between the public and the private (GUIDDENS, 1995), and established a structural change in the form of financing and providing infra-structure services (PECI & SOBRAL, 2007). The proposal is that, through the PPP, the State will allocate resources from the private initiative for projects that have no economic and financial feasibility by themselves, requiring a match through budgetary donations. In this way, a PPP arises as an alternative to the classical forms of privatization and for public concession with an expected contribution to permit joining the advantages of the involved parties and making feasible, economically and financially, the projects that, by another means, could not be accomplished by the State.

Following an international trend, in the year 2004 the Federal Government sanctioned the Law no. 11.079, or the Law of the PPPs, an ample program of partnerships between the state and the private initiative. The legal norm deals with the general procedures for a PPP bidding and contracting, in the context of the Powers of the Union, of the states, of the Federal District and the municipalities, with the main focus on the creation of conditions for achieving investments, particularly for projects of infra-structure, a sector in which public resources are scarce.

In the PPP, the contribution of the State can be in various forms. For example: building and transferring the operation to the private initiative; compensating the private initiative for the efficiency of their management; receiving assets from the private initiative, but keeping the operation in their hands, or yet, complementing the cost of the enterprise. Or even all these conditions combined.

The contacts made on a PPP basis have the intention of utilizing the qualities of partners in the establishment of cooperative relationships, characterized by risk-sharing, costs and profit. Fundamentally it is to take advantage of the characteristics of each sector of the economy in which the projects will be implemented, contracting the specifics in order to guarantee that the society receives a more efficient and a better quality service or a public project.

Two basic types of partnerships are present in the Brazilian regulatory system, the Sponsored Concession and the Administrative Concession. The PPP Sponsored Concession is the concession for public services or public projects when the type of

concession and permission for providing public services involves, in addition to the fees charged to users, financial accounts from the public to the private partner. Thus, by means of a previous contractual stipulation, there is the possibility of linking the release of resources to the offer of usable installments – such as a stretch of road – resulting in a larger availability of resources on the part of the private partner in advance, before being able to receive for the services that are being rendered.

The Administrative Concession PPP is a contract for providing services which has the Public Administration as a direct or indirect user, even if it involves the execution of a public project or the supply and installation of goods. The administrative concession is totally paid for by the Public Power, and it can be exemplified by the construction and financing of a jail or a government administrative center.

Despite the established definition of the legal arena, experiences with PPP projects in Brazil in the federal arena are still quite limited, lacking formalization of any project. The Brazilian experiences are only concentrated in the state and municipal spheres. As a result, many of the contractual problems of the existing PPPs still suffer from a lack of conciliatory solutions, as an example, the use of arbitration or administrative follow-ups, taking legal disputes to the Judiciary, be it for a lack of specification in the decisions, or for a delay in the final judgment, resulting in additional costs to the process.

3. Problems of agency in contracting processes

As discussed previously, the process of making the state action flexible are based fundamentally on contracting mechanisms. Thus, it is necessary to seek a theoretical framework for contract theories, in particular for agency theory, the indicators about the problems involved in these processes.

In a contracting process, there are at least two sets of dissimilar, or even divergent, interests, although in certain PPP structures the set of interested parties can be even greater. If, on the part of the private partner the main concern lies in maximizing profit, adjusting the rate of return for the risks that will be taken during the entire investment period, and in the duration of the period of the PPP in an unstable political and economic scenario, on the state's end there is a desire to identify a partner capable of providing good services to citizens and, consequently, obtain political gains through these projects, by addressing society's demand.

Moreover, according to the contracting mechanism utilized, the shape of a society of specific purposes (SSP) can be present, besides a bank financing the operation, as well as various other players. Figure 1 shows schematically the set of players involved in a typical PPP process.

CONTRACTING
PUBLIC AUTHORITY

Banks Financing contract Concession contract Building contract
Investors Stockholders' agreement **SSP** Building contract **Builder**
Multilateral Insurance Companies insurance contracts/guarantees Operation contract
Operator Operation contract **Users**

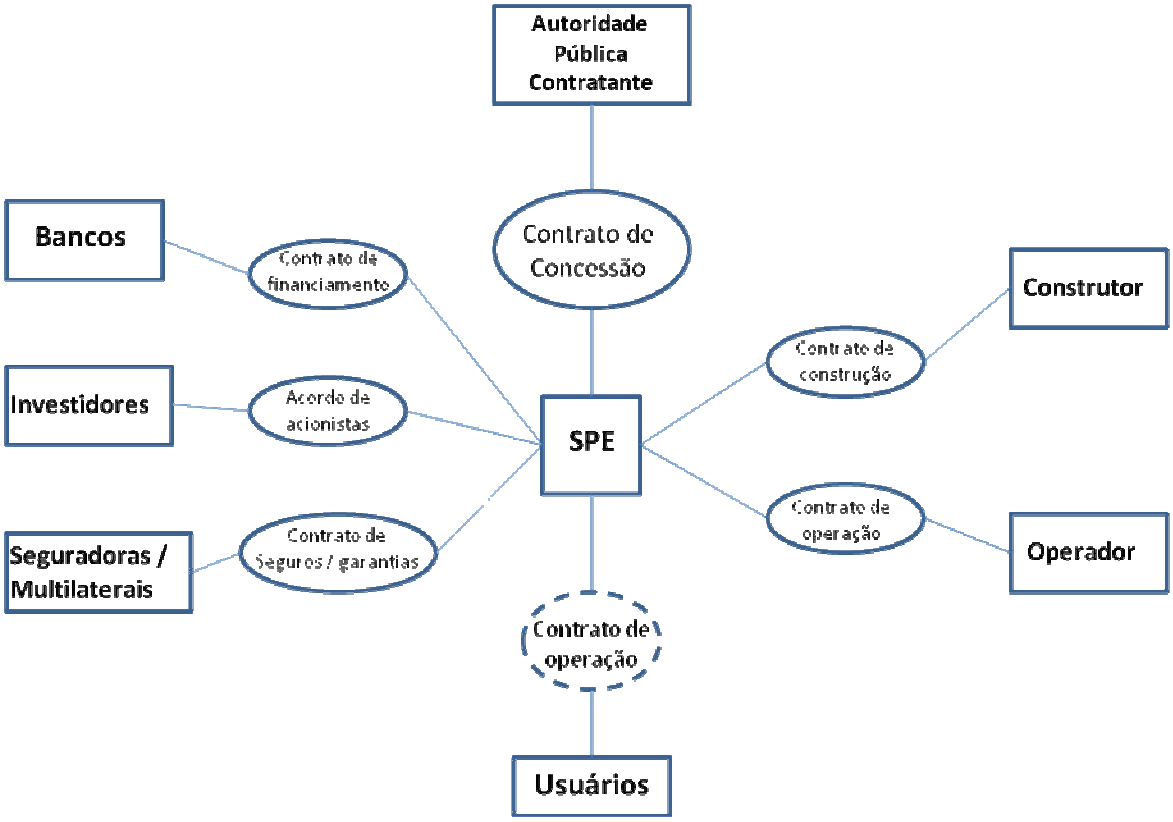

Figure 1: Contractual relationship among various agents involved in a public service concession
Source: Barbosa & Brito, 2005.

Taking into consideration, therefore, the main agency relationships involved in a contracting process, it is possible to highlight the following problems:

- The investor needs to be sure to receive a return on the money invested and, regarding this aspect, it is important to consider the forms of financing his enterprises – internal and external (ANDRADE & ROSSETI, 2007);
- The State needs to ensure that the private entrepreneurs, represented by the executive managers that lead the company, will not expropriate the investment of which the State is a participant, at least in terms of the purchaser/contractor of the investment project;
- The existence of the appropriate legal and institutional insurance is indispensable, so that both (the State and the private initiative) obtain the expected return on a given investment project.

Those statements are fundamental for us to think about the possibility of making the State action flexible. To that end, the identification and knowledge of eventual conflicts among these players – the State and the private initiative – based on the Agency Theory, becomes essential for a definition of the concept of making the state action flexible.

Agency Problems or Agency Conflicts are typically treated by the Agency Theory, a standard reference in the field of corporate governance which, according to Klein (1983) and Jensen and Meckling (1976), is associated with two fundamental axioms: the inexistence of a complete contract and the inexistence of a perfect agent.

In reality, the Agency Theory deals with transfer of wealth between the principal and the agent, occurring when the former delegates power and authority to the latter to make decisions, a moment in which appears the possibility of transfer of the mentioned wealth. The assumption of theory, according to Segatto-Mendes (2001), consists of treating costs resulting from the loss of wealth from the principal in the transfer to the agent executing the actions that result in benefits. In the case of transferring the execution of the action from the principal (State) to the agent (private entity), the principal incurs the costs to ensure the effective and efficient accomplishment of the contracted people, for which actions of control and incentives are necessary.

In a more general manner, the Agency theory seeks a better understanding of the incentive systems or contractual forms that regulate the interests between these players (EISENHARDT, 1989). It recognizes that various reasons can be factors causing conflicts of interest, not only differences of motivation and objectives between the principal and the agent. Thus, situations in which there is, between the parties, asymmetry of information, difference in the preference for risk, and/or difference in the planning horizon, could generate agency conflicts.

The distinctive motivations between agent and principal may result in little or almost no fluidity in the course of information between these players, thus creating an environment of informational asymmetry. It is, therefore, relevant that we know the degree of this asymmetry, since the ability to observe the environment is not complete; otherwise, we would have more transparent information and, consequently, the principal could outline a perfect context, without conflicts. However, the information that the principal receives is not provided in their entirety by the agent, allowing ~~this~~ ~~one~~ (the latter) control and manipulation of the terms and results of the contract.

According to Arrow (1985), the hidden action (moral risk) and hidden information (adverse selection) also stem from the problem of information asymmetry in the agent-principal relationship. The hidden action can be created when the agent makes observations that the principal is not capable of doing. In the case of the PPPs, for example, the agent may argue that he reached the set of goals established in the concession contract, which occasionally may not be true. The principal may not have instruments to verify if the agent utilized this information in the best possible way in relation to his interests. The information of the principal is generally obtained from the results reached by the agent at the end of each process or decision-making point, and perhaps, from the little he is able to obtain through monitoring, which uses costly and complex systems. Still according to Arrow (2005): "In the problem of hidden information, the agent makes some observations that the principal is unable to do. The agent uses this observation and makes decisions. Nevertheless, the principal is unable to verify if the agent used this observation in a possible way for the principal's interest."

Jensen & Meckling (1976) classify the mechanisms designed to minimize the problems of an agency relationship in three modalities: (a*)* monitoring costs, which are the ones incurred by the principal to monitor the agent's job, such as exemplified by audits; (b) bonding costs, which are incurred by the agent and created at the company,

with the intention of allowing the principal to verify if the agent acts according to his own interests, such as reports and specialized evaluations (Hill and Jones, 1992); (c) costs with residual losses, resulting from non-optimum decisions inherent to a conflict of interest.

Applying this theoretical framework to the case of concession of public services, understanding PPPs as particular cases of concession, the theory may require particular considerations since, as discussed, many of these projects involve various agents simultaneously, and the creation itself of an SSP prior to the implementation of the contract, with the public entity, in charge of implementing and managing the object of the partnership. In spite of the State not being the owner of the SSP, it is the one who dictates the rules of execution of the contract, taking charge, to some extent, the ascendancy in terms of hierarchy. This prerogative causes the State to have a role, at least theoretically, of a *quasi*-proprietor or a stockholder of this SSP. The structure of multiple agents brings, thus, non-trivial theoretical challenges.

4. Regulatory instruments utilized by the Brazilian State to deal with the contracting problems in the flexibility strategies

Since the beginning of the 90's, the Brazilian State has been adopting various measures to promote structural adjustment of the economy, including accelerating the process of economic opening and privatization, fiscal adjustment, currency stability, and a movement for an institutional reform of the State.

In relation to the movement for making the state action more flexible, it required from the State the development of a new set of regulations, aimed at stimulating and guaranteeing the private investments necessary for social well-being, in addition to increasing economic efficiency. It was in this context that a debate about market regulations began to take shape. At the time, the first experiences with regulatory agencies were born as well. To establish, qualify, and reinforce sectorial processes of regulation became essential to strengthen and stimulate the development of markets. At the same time, it is fundamental to attract private capital for investment in sectors in which the State occupied a unique position.

According to Pires & Piccinini (1990, p. 220), some assumptions of the regulatory mission are to seek economic efficiency, guaranteeing the lowest-cost service to the user; avoid the abuse of monopoly power, ensuring the smallest difference between price and cost, in a compatible way with the desired levels of service quality; ensure universal service; ensure the quality of the service provided; establish channels to respond to users' or consumers' complaints on the services provided; stimulate innovation (identify opportunities for new services, remove obstacles and promote incentive policies for innovation); ensure technological standardization and compatibility between equipments; and guarantee safety and protect the environment.

Farias & Ribeiro (2002) list recommendations developed by the late Council of State Reform – CSR – which presented the following objectives for the regulatory function: promote and guarantee market competiveness; guarantee consumers' and users' rights to public services, stimulate private national and foreign investment, seek quality and safety of public services, for the smallest cost possible; guarantee adequate return on investments made by the service providing companies; solve conflicts between

consumers and users, on the one hand, and service providing companies, on the other; and prevent abuse of economic power by the agents providing public services.

However, to develop this regulatory mission is not an easy task. According to Pires & Piccinini (1990), this task requires definitions about the presence of independent agents: control and exit of the market, through a concession of licenses to operators, whenever is the case; regulating the competition; defining the value and the revision criterion for fee readjustments, with the use of efficiency mechanisms; and monitoring the concession contracts.

Independent Agencies

The challenge placed upon the regulatory agencies is large, being that their roles are decisive for the success of making the state action flexible. However, the type of operation which the agencies are going to adopt constitutes a determining factor for success in the accomplishment of their objectives.

Hence, some characteristics need to be institutionalized in their internal structures so that a standard of excellence can be reached that is desired by the regulatory companies as well as by society at large. Autonomy to act with independence; stability of its corps of managers; specialization of its staff; transparency in the dissemination of information; and regulated allocation in its statutes are part of the important roster of necessary characteristics.

Independence, including from the financial point of view, vis-à-vis the development of the public budget, will enable the regulatory agency to act with sufficient authority to perform conflict resolutions, without taking the risk of being questioned by resources managed by other authorities of the Executive Power.

Having a stable management will also permit the assumption of a position of greater independence as long as, even if there is an opposing position to that government, this does not lead to the dismissal of their executives for political reasons.

The specialization of the services staff in the regulatory agencies is a fundamental requirement, without which one cannot, at least comfortably, reduce the information asymmetries eventually appearing between the parties, considering the complexities and the specificities involved in each one of the questions raised, which will require a just and timely conflict resolution.

Even though the actions of the regulatory agency may be noble, the evaluation must be made by its representative organs, as well by society as a whole. To that effect, the implementation of its activities must be conducted with total transparency, also fundamental to ensure social legitimization. Information regarding the practice of public hearings prior to decision-making, the description of functions and attributions of the regulatory agencies should be part of the composition of their articles of association in order to give essential transparency and also to ensure an increase in the capacity of supervision of consumers in regards to the fulfillment of the regulatory mission of the regulator.

Finally, at least part of this profile described by the regulatory agency must be extended somehow to the regulated company, especially with respect to publications of information about quality performance. As Rovizzi & Thompson *in* Fiani (2008) remark, the incentives for an improvement of performance of the regulated company, as long as

the company holds a monopoly position, are very scarce, besides the ones stemming from pressure of public opinion.

Control of entry and exit from the market

If, on the one hand, it is important for the State to create mechanisms that ensure the private company – user of the concession – its permanence in the business during the entire period of the contract, be it through creating, by the State, barriers to the entry for newcomers, on the other hand the company is also obliged to remain loyal to this concession period; for its eventual leaving or operational cancellation prior to the initially predefined date can cause serious damage to the Conceding Power as well as to consumers.

Regulating the competition

In this instrument of regulating policy, the regulating agent assumes a more indirect interventionist position, that is, by monitoring the competitive structure existing in the market, aimed at creating the most neutral environment possible for all agents. One of the key points in this scenario is the need for the regulating agent to carefully evaluate the opportunity for making price controls flexible, assuring this does not occur at an inappropriate moment on the agent's side, possibly resulting in losses to consumers.

Tariff value and incentive mechanisms

In general, the companies, based on the Internal Return Fee – IRF - that a given business might create, decide to allocate resources on a particular investment project. Thus, in order to become economically feasible, one needs to be able to pay for the different capital costs employed in the investment project.

Based on this premise, the regulating agents developed a series of tariff regulations which took into consideration the IRF that the regulated companies should receive. However, even though this criterion is more concerned with guaranteeing a balance between cost and revenue of the company, allowing it to receive some profit, there was no similar concern in the practice of incentives for cost reduction on the part of the companies, given the guaranteed compensation for investments and ~~of~~ the eventual passing of costs onto the consumers.

Due to this distortion between the guarantee for return and the lack of incentive for cost reduction, a mechanism called price-cap was developed, which intends to establish incentives for the productive efficiency of the company, based on the regulating agent's definition of price-cap for average-prices or for each product of the firm, adjusted according to an evolution of a price index to consumers and subtracted from a percentage equivalent to a productivity factor for a period of years.

However, when a regulated company is subject to a price-cap, it is always more lucrative to offer a lower quality to that coefficient, since, although an increase in the quality may yield some increase in demand, the company might not be able to attract those consumers for whom this item is not so apparent and relevant. Obviously, this situation will only be economically advantageous to the firm if the loss in revenue

stemming from the reduction in the quantity sold is less than the reduction in costs provided by the reduction in the same amount sold.

For this reason, in the sense of avoiding a reduction in the quality of the service provided by the regulated company, the solution would be to incorporate an adjustment element to the price of the agent's service determined by the quality level. Hence, an eventual decrease in quality would mean an increase in the discount factor of the price-cap. The advantages of this solution would be: The establishment of an automatic incentive which, once defined, would not require any type of intervention from the regulating agent, which would significantly decrease the transaction costs; the regulated company would have freedom to choose a price/quality combination most relative to its costs and conditions of the demand, which tends to create an efficient solution without the regulating agent's intervention.

In addition to the price-cap, another type of regulation is what is called Yardstick competition or Benchmark. In this case, the principle is to introduce competition to induce efficient behavior, because the performance of the regulated firm is compared to similar firms in different markets or with a prototype firm. Hence, the profit allowed is based on relative performance. This instrument, in fact, seeks to stimulate price reduction between companies, to reduce the existing information asymmetries, and to stimulate greater economic efficiency.

Monitoring contracts

Despite the high costs and complexity that involves the monitoring of regulated companies, this monitoring instrument is indispensable for receiving the quality of the services provided. The supervision of the contracts will allow us to verify the achievement or not, of the goals and other requirements established in the business plan submitted at the signing of the concession contract. Therefore, the ideal is to have a definition of penalties for the non-accomplishment of performance and quality goals, for the issue of a minimum quality standard is critical, and is a frequent source of asymmetry between service providers and consumers. Hence, this regulatory instrument is considered one that assumes an essential role to the entire society.

5. The EcoUrbis Environmental case

With the purpose of understanding the context and problems resulting from strategies for making the state action flexible, a case analysis of a concession experience was conducted, which, for its nature, bore also similar characteristics and structures to a PPP. The chosen company, the EcoUrbis Ambiental S.A., is a specific purpose company (SPC), which since 1994, operates based on a concession of collection, transportation, treatment and dumping of residential and medical waste in the southeast areas of the city of São Paulo, the capital of the state with the same name, which encompasses 18 sub-municipalities, from the East District to the South District. This happens to be one of the largest companies in the industry in Latin America. It is necessary to emphasize that the nature of operation of EcoUrbis takes on a very special character, especially in regards to the difference between the public service provided by a trash collection company, with all

the associated social and environmental impact, and for another one, responsible for a road toll.

In the design of the case, public as well as private documents authorized by the company were used. In the description and the following analysis, in order to relate the case to the theoretical framework, the company contextualization and its process of creation are presented, along its motivations to participate in the process of public bidding, and explanations about the current political environment were also put forward.

a. The launching of the bidding announcement and some characteristics

On 08-20-2003, the Town Hall of the municipality of São Paulo published the Bidding Announcement as a competition, evaluated by the criterion of a tariff's lowest price, in an attempt to select the most advantageous proposal for the grant of urban cleaning services, by means of a concession. The legal norms that regulated the announcement were the Federal Laws no. 8.987/95 and no. 8.666/93, in addition to others that are part of the judicial ordinance of that municipality.

The competition and the announcement were preceded by a public hearing, the former on 04-14-2003, and the announcement on 07-16-2003. The deadline set for the concession was 240 months, renewable for the same time period. The grant for the public service was directed towards two different regions of the city – Northwest and Southeast. EcoUrbis won the process to work in the Southeast area of the Municipality. The value of the contract initially estimated in the Announcement for the second grouping was R$ 4,498,345,950.00, and the monthly reference tariff to be paid by the municipality was estimated at R$ 18,743,108.12.

The municipality attempted, through the announcement, to minimize the negative impacts that could occur in case some unprepared proponent intended to participate. Therefore, rules were established so that the participant's judicial capacity, financial history, fiscal responsibilities, and technical capacity could be proved

Finally, the demand for a form of the SPS – Specific Purpose Society – was also present in the Announcement. The company and/or the winning consortium should establish a SPS that would make a concession contract with the Conceding Power and only this one could approve any eventual change during the concession period.

Thus, addressing the terms of the Competition Announcement on 09-29-2004 the company EcoUrbis Ambiental S.A., a Specific Purpose Society (SPS) with the main objective of meeting the obligations resulting from the concession Contract signed with the Department of Services and Works – SSW of the town hall of São Paulo as a result of the Public Bidding no. 19/SSO/2003, pertinent to the so-called LOTE – Southeast Complex.

b. The political environment on the contracting

The proposals of the town hall of the city of São Paulo from the period of 2001 to 2004 for continuing with the contracting mechanisms were characterized by numerous arguments and disputes, particularly with regard to services provided for garbage collection. Even though the public bidding process ended at the end of 2003, its

formalization process only occurred in 10-06-2004, when the city and the winning consortium signed the document.

In January of 2005, that is, three months after the signing of the Concession Contract, a new government takes over the municipality. On this occasion, a representative belonging to another political current tide is appointed, coming from the main opposition of the previous government. One of the highlights in the beginning of this new government is the edition of a municipal Decree n. 45.684, of 01/01/2005, that determined to the organs of the Administration the implementation of measures and studies aiming at the reevaluation of the contracts then in effect.

The adoption of those measures by the municipality caused doubts about the value of the contract previously signed with EcoUrbis and, unilaterally, reduced the value of the monthly fees until Ocober/2007, when a new agreement was made between the parties based on a study conducted by FIPE, an institute associated with the University of São Paulo.

On 10-26-2007, EcoUrbis and the municipal Town Hall of São Paulo signed an Environment Compromise Term - ECT (process no. 2004-0.235.349-4), with the objective of establishing sustainable development of services and of investments appearing in the concession contract. Next, we highlight the main points of this agreement which, in reality, consisted in fact of a contractual addendum:

- global reduction of 17.34% of the tariff originally contracted, becoming a tariff of R$ 21,619,690.94 per month (estimated value for the contract - R$ 5,188,725,826.00);
- the town hall recognized the difference between the new tariff and the one actually paid from the period of 01-01-2005 to August of 2007, in the value of R$ 71,434, 304.20, to be paid in ten consecutive installments beginning in October, 2007.
- suspension of the investments and of the effects of the benefits introduced by the Municipal Law no. 14.125/05;
- the TCA did not lead to a recognition, on the part of the Administration of the town hall of São Paulo of the Contract n. 26/SSO/04 (an issue that is currently "*sub judice*");

Until December of 2008, there were eight judicial actions made up of supposed irregularities in the bidding procedure and in the contracting, knowing that there was not, at least until that date, any preliminary measure or decision in effect recognizing the illegality of the Contract, and much less, preventing its implementation.

After an interview with the president of EcoUrbis and the company's lawyer, we were given some clarifications on the existing judicial actions against the concession contract:

- the events refer to the period between the signing of the Concession Contract (10-06-2004) at the end of the previous mayor's term of office, the beginning of the services provided by EcoUrbis (10-13-2004), and the beginning of the transition of the mayor-elect (January of 2005), the time when the Decree Law no. 45.684/2005 was signed, which cancelled various contracts made by the previous administration.
- upon EcoUrbis' request, still during the administration of the previous mayor, the business plan of the concessionaire was revised and cited by the Fundação Getúlio Vargas – FGV. Later on, already during the administration of the mayor at the time, upon the municipality's request, the Foundation Institute of Economic Research - FIER – conducted a careful analysis and reevaluation of the EcoUrbis accounts,

which made it comply to the items of the Decree-Law no. 45.684/2005, regarding the formalization of the "Term of the Environmental Compromise", published in the Daily Gazette of the Municipality of São Paulo, on 11-02-2007, which, in reality, is characterized as an addendum document of the referred concession contract;

c. The conceptual model of the study and the Agency problems identified in the case.

The basic conceptual model of the study, presented in Figure 2, is a representation of the conducted research and was designed based of the theoretical framework of this study. In this graphic design, the three players involved in the process of making the state flexible are present, either to a large or small degree; a) The Private Sponsor, who by definition has no other direct link with the State regarding the specific project pertaining to the public concession, but, on the contrary, participates in the SPS. We classified this player as belonging to the "zone of relative relationship"; b) the principal, represented by the State, that is, the Conceding Power, which makes the actions flexible through partnerships with the private initiative, and finally; c) the Agent who, through the SPS, will implement the investment project according to the orientations established in the public bidding process. These two last players are within the so-called "zone of relative relationship".

It is worth clarifying that in the design of the figure, we decided to utilize a dotted line connecting the Principal to the Agent (SPS), for, unlike the connection between the Private Sponsor and the Agent, who have a formal and societal relationship, this connection between the Principal and the Agent is not formal in societal terms. However, the control of the various management practices adopted by the Agent is something that is usually pursued and carried out by the Principal. In reality, to clarify this statement, it is assumed that the State, when in the public bidding process - be it through a bidding announcement or a Concession Contract – attempts to establish criteria for controlling, monitoring and following-up the SPS operation and business, which to some extent, make the State assume a position similar to a business owner.

Due to this position, regardless of the existence of two different areas of relationship, some worsening of the relationship between the Principal (State) and the Private Sponsor may occur.

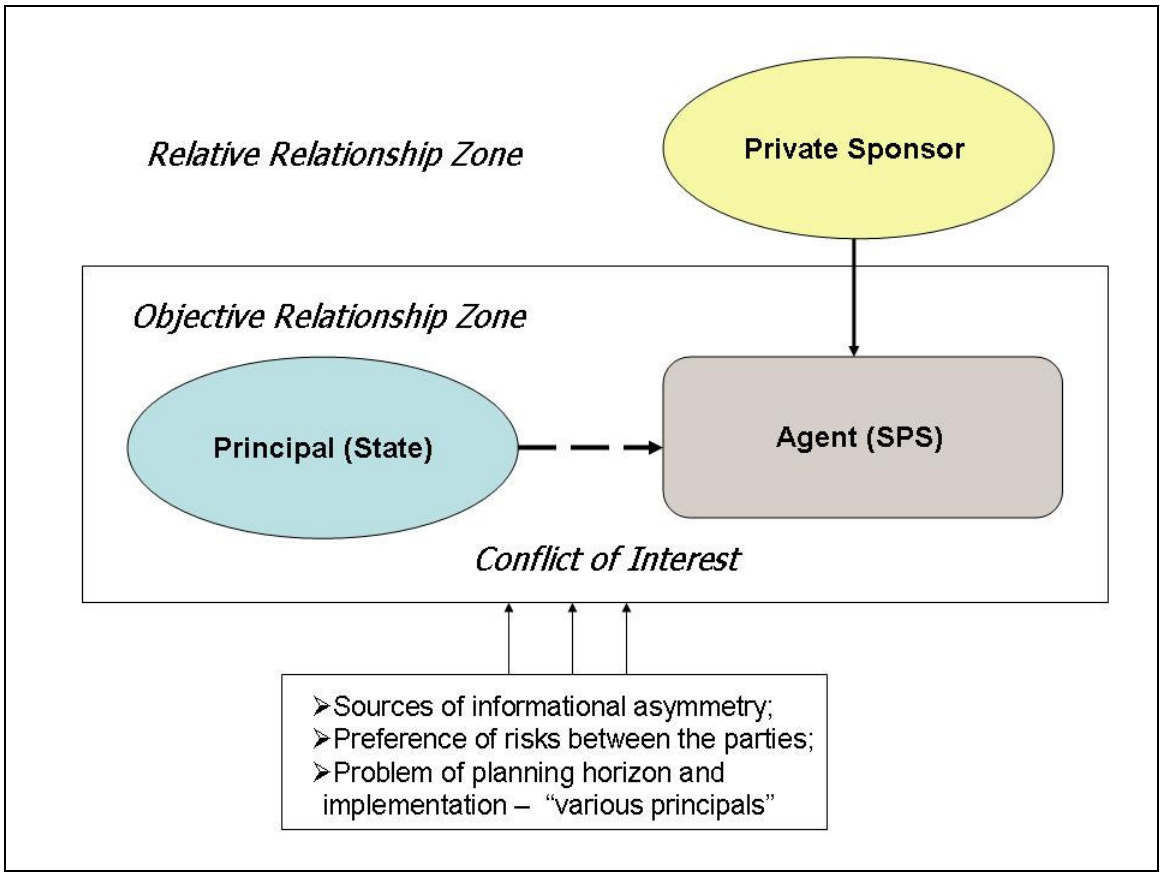

Figure 2: Basic conceptual model of the study

After making the state action flexible, resulting in the partnership between the public entity and the private initiative, a possibility for conflicts arises, analyzed below according to the association with the three different groups: I) *Sources of Informational Asymmetry*; II) *Preference of Risks between the Parties* and III) *Problem of Planning Horizon and Implementation*.

For the three groups described above, we identified, based on the Concession Contract no. 0262004-0.235349-4, of 10-06-2004, and also in the Term of Environmental Compromise, how conflicts between public and private partners may be defined, as well as which contractual clauses attempted to deal specifically with the possibility of each one of these conflicts.

In reality, our proposal was to extract from these documents indications that possible conflicts could arise and remain in case those contractual terms were not mentioned. Therefore, the elucidation of these terms typifies which eventual conflicts were being treated. Another issue to be pointed out is the existence of clauses that suggest a solution to those possible conflicts. The simple write-up of those clauses allows us to evaluate the probability of occurrence of the problems. Nevertheless, in this work, we are not emphasizing the solution proposed by the Principal, nor making any judgment regarding the appropriateness and opportunity of the clauses. The transcription had the sole purpose of identifying the possibility of the existence of a conflict.

Informational Asymmetry

- Clause 6 – On the Concessionaire – items 6.4. and 6.5. – *"6.4 – On April 30 of each year, AMLURB will perform a inspection of the approved capital of the Concessionaire, with the purpose of also ensuring its proportion with the investments accomplished and to be accomplished;* ***6.5.*** *– The Concessionaire and its controllers agree to maintain, during the entire period of the concession and its extension, the conditions of qualification and preparation required in the bidding and existing at the time the present contract went into effect".*

The Conceding Power establishes a clause that suggests the possibility that the information does not flow so very well, to the point that the initial standard of excellence goes through a negative change. Incidentally, this announcement was the topic of a public hearing, having been amply discussed between the interested parties, and being finally accepted and approved by everybody. Yet, given the possibility of existence of informational asymmetries, the Principal determines formally that the Agent complies with the control and monitoring rules on the part of the Conceding Power.

- Clause 8 – On the Rights and Obligations of the Concessionaire – Items 8.2.I, 8.2.VI, 8.2.IX and 8.2.XXVI – *"****8.2.I. –*** *provide the services granted, observe the principles of regularity, efficiency, preservation of the environment, universality, transparency, participation of the municipal user in the control and inspection of the services implementation, modernity, security, being up-to–date... 8.2.I, 8.2.VI, 8.2.IX e 8.2.XXVI – "8.2.I. – provide information and accountability of the management service to AMLURB, on the terms defined in clause 17 of this Contract, as well as, provide all information of a technical, operational, economic-financial and accountable nature and others required by AMLURB;* ***8.2.IX*** *– "comply with the AMLURB inspection, allowing access of its agents at any time to the work, to the equipment and facilities involving the job, as well as the accountable records.* ***8.2.XXVI*** *– provide for the conducting of an opinion poll on the municipal-users of the services provided, qualitative and quantitative, in the manner and frequency stipulated in the Addendum I of the present Contract";*

In addition to the previous item, we must highlight in this clause the issue of transparency and control by the municipal user, that is, now the monitoring pertinent to the Principal's activity also passes to the end user of the service. This seems to be another attempt to diminish the informational asymmetry problem.

- Addendum I of the Concession contract Item F (modified by the Term of Environment Compromise) - "Inspection by means of tracking and monitoring vehicles for the collection and transportation of solid waste and facilities for treatment and final waste disposal for the city of São Paulo – FISCOR". Having the following scope: "Offer AMLURB computer resources to follow up on the implementation of services, from the collection of solid waste, passing through Transshipment Units, Composting Plant, Sanitation Landfills, Treatment Station, and Final Disposal of residential solid waste, monitoring the routes of the vehicles for residential solid wastes and for health services, as well as of the vehicles utilized in the transshipment stations for transferring waste, interacting with the System for Control of Urban Solid Waste, currently the SCUSW (*SISCOR*); and the System for Citizen Services,

currently the SCS (*SAC*); providing monitoring and storage of information which will enable us to infer the level of the service provided and the operation cost, as well as managing the quality of the job done by the Concessionaries";

In addition to what has been said in the previous items, we emphasize the issue of the computerized monitoring system imposed upon the activities performed by the Agent, which should also make available a "mirror" of the operational system to the Principal, so that he can follow up, in real time and simultaneously, the progress of the services provided, making the appearance of asymmetries in the information provided difficult. As a matter of fact, upon visiting the company, on the occasion of our research, we had some evidence that the monitoring system had been satisfactorily meeting the demands of the Principal.

Preference of risks between the parties

- Clause 11 - Item 11.1. – ***11.1. -*** *The Concessionaire will explore the object of the concession on its own account and at its own risk, being compensated by a fee to be paid by the user, in the form…";*

As we can observe in this clause, the Agent will be responsible for assuming the business risk, confirming Sappington's (1991) proposal, when he states that the Principal assumes a position of a greater risk aversion.

- Clause 11 – On Insurance Plans Item 18.1. – *"**18.1.-** During the entire period in which the contract is in effect, the concessionaire must maintain, with the Insurance Company, the following insurance premium to guarantee an effective and encompassing risk coverage inherent to the development of all activities contained in the present Contract: I – premium of the type "all the risks" for material damage covering loss, destruction, or damage in all or in any asset involving the concession, and such premium must include all coverages contained therein according to international standards; II – civil responsibility insurance, which includes all and any accident with Concessionaire's directors or employees and with third parties, covering any loss that might result from or be related to the implementation of the public work the present Contract deals with or of the Infra-structures in it mentioned.*

Even though the Principal assumes a greater risk-aversion position and, consequently, the agent assumes a more neutral position (in relation to it), there was a demand from the Principal that the Agent decrease those risks with the insurance companies which, in a final analysis, reinforces the position assumed by the Principal.

- Clause 8 – On the Rights and Obligations of the Concessionaire - Items 8.4 e 8.5 - *"**8.4. –** While this contract is in effect, the Concessionaire will be solely responsible for third parties, for the acts performed by its personnel, directors, and contracted people to provide the service, the object of this Contract, as well as for equipment or facilities use, excluding the Municipality and AMLURB from any complaints or compensation. **8.5**. – The Concessionaire agrees to implement on its own account and at its own risk, the construction projects, expansion, modernization, and maintenance of the Infra-structure, specified in the Addendum I and III of the present Contract, in the form and time frame established in this Contract and in the Proposal".*

Once again, the risks for the implementation of the contract are totally transferred to the Agent.

Problem of Planning horizon and implementation

- Clause 5 – On the Contract Deadline and Extension Conditions - Item 5.1. *"**5.1.** - the contract deadline is 240 (two hundred and forty months)…"*.

It is interesting to observe that, not only in this clause but also in the entire Concession Contract there is no mention regarding the possibility of addendums to the Contract during the period it is in effect. However, as mentioned, there was in fact this situation as a result of changes in the government at the time of municipal elections.

- Clause 6 – On the Concessionaire – Item 6.6. – "6.6. - Any change in the make-up of stockholders of the Concessionaire will depend on previous and expressed agreement from AMLURB, especially the break-up of operations, mergers, acquisition, capital reduction, or transfer of partnership control".

It is worth mentioning here that, with regard to the company, there is a contractual restriction on any partnership change made by it. However, the shift in power, common to the State, is not taken into account in the formal aspects of the Contract.

- Clause 8 – On the Rights and Obligation of the Concessionaire - Item 8.1. II – *"**8.1.II.** – to have the economic-financial balance of the Contract maintained, in the terms contained in the clause 15."*

Even the existence of this contractual clause did not hinder a renewal/addendum of the Contract with a fee reduction, decreasing the TIR initially estimated for the enterprise;

- Clause 15 – On the Protection of the Economic Situation of the Concessionaire and of Fee Regulations – Item 15.14 – *"**15.14**. – Independent of the revision procedures of fees started by the parties of the present Contract, AMLURB will proceed with a regular fee revision…every 5 (five) years…."*

The shift in power, possibly every four years, creates a potential environment for the appearance of conflicts, as the new State representatives (Principal) may attempt to impose new fees based on political motivations, which will certainly be questioned by the Agent.

- Clause 21 - On Arbitration - item 21.1.I – "*The eventual conflicts that may be raise in terms of application and interpretation of the Contract norms will be resolved in an administrative branch by AMLURB, being that the Concessionaire is able to appeal the arbitration procedure contained in the present Chapter except when not in conformity with AMLURB´s decision regarding the following matters: I - violation of the concessionaire's right to protect its economic situation as written in the Clause…"*

Even with the possibility of establishing arbitration, EcoUrbis chose the administrative/business paths, despite the lack of payment of the monthly fees by the Conceding Power for a period of three months. From our point of view, the decision to address this issue by these paths was due greatly to the new political environment in place at that time. Perhaps a decision for arbitration, considered legitimate contractually,

would allow the company to maintain the fee value initially estimated in the Bidding Announcement. However, the consequences of a "politically inappropriate" attitude could be damaging to the continuance of the relationship between these players.

Finally, considering all the clauses above presented, as well as the pertinent observations regarding each one of them, we came to the conclusion that, for the State, anticipating the possibility of the creation of conflicts in the fields of Informational Asymmetry, Risk Preference between the parties and the Time Horizon Problem yielded the design of a document that could mitigate part of these conflicts.

5. Conclusion

This study searched for evidence of the main conflicts existing between the State and the private initiative and their encountered solutions, noticeably when the latter attempts to expand its capacity for action, making its performance flexible based on the establishment of partnerships with the private sector.

We used the Agency Theory as a framing instrument of our theoretical investigation. Hence, it was possible to perceive the presence of some critical variables in the Principal-Agent relationship. The problem of informational asymmetry between the State and companies, the preference of risks that each one of these actors has and the problem of the temporal horizon were the variables analyzed in our study.

As the literature shows, the emergence of conflicts in the Principal-Agent relationship is unavoidable. Therefore, we attempted to identify how these problems are manifested in the flexibility strategies and which would be the main instruments to be utilized by the State to deal with these situations. Independent agencies, control of market entry and exit, regulating competition, tariff cost, incentive mechanisms, and monitoring of contracts were cited as those instruments which, somehow, could contribute to minimizing conflicts.

With the purpose of better explaining how the Principal-Agent relationship works, we utilized a case study from the company EcoUrbis S.A. The company and factors that involved the strategy for making the state action flexible enabled us to understand how the assumptions of the Agency Theory could be applied to describe the conflicts resulting from the adoption of this model of partnership between the State and the private initiative. The methodology utilized contributed to our answer to the initial problem of our research, as it revealed how the agency problems play out when the State decides to make its action flexible in partnership with the private initiative to develop an investment project.

Based on the framework proposed by the Agency Theory, it is possible to conclude that, regardless of the market segment, the participants' characteristics or even the type of partnership that one may establish, some room will remain for the existence of conflicts in Principal-Agent relationship. However, in any case, these conflicts will almost always have very similar patterns, which will enable us to identify them and intervene with the use of instruments that aim at minimizing them.

Still in reference to the general objective presented, the study limited itself to research the way the agency problem can be defined regarding the flexibility of the state action, without considering other variables, such as political motivations, agency costs and other formal instruments contained in the process. In spite considering also

fundamental all these other aspects pertinent to the theme, they were not the object of this study.

It seemed, in principle, an anachronism to discuss flexibility for the State given an environment of economic crisis and increasing recession in the majority of the countries, when proposals for greater state intervention and regulation prevailed for solving the problems which the market appeared not to be able to face. Nevertheless, one needs to consider that, to a greater or lesser degree, the growth of the relationship between the State, the private initiative, and the third sector in the solution of problems and satisfying societal demands is a road with no return. Therefore, studying these flexibility strategies is justified as a present and future problem.

The analysis of the contractual clauses, besides proving the applicability of the Agency Theory to the flexibility processes of state action, demonstrate that other contributions of the theory can be investigated to analyze these State-private company partnerships, which will be able to help improve the management of these investment projects. One of the contributions would be a more discerning study on the operation of the arbitration venues for conflict resolution; another contribution would be the implementation of a more accurate evaluation of the companies that operate in the same segment as the ones that were formed based on making the state action flexible, in order to compare their financial-operational result. In the case of the municipality of São Paulo, the public bidding established that the trash collection service would be shared by two different companies, that is, two large concession blocks. In our study, we only evaluated EcoUrbis, belonging to Bloc 2, Southeast region.

Finally, amongst all these substantial changes in the macroeconomic scenario, the only thing that was not changed was our certainty that the path that combines competence and flexibility in the management of resources in the private initiative and the need to expand the spectrum of social investments with the least possible impact to the State treasury– is true and lasting.

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