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# Ex-Post Governance.

## The Case of Defense Procurement Contracts

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# Introduction - Objectives

- Identifying and explaining *ex post* governance choices
  - What contractual decisions in face of adverse events?

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# Introduction - Motivations

- Governance decisions are original in the French defense procurement sector
  - It can be used as a starting point for brain storming
  - These governance choices are partly explained by specific features of the defense procurement sector
    - Some of them are shared with other sectors

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# Introduction - Outline

- 1. Features of defense procurement contracts
- 2. Relational governance...
- 3. ... but not incomplete governance. The case of risk allocation

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# 1. Features of defense procurement contracts

- 1.1 Data
- 1.2 Main economic features

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# 1.1 Data

- **250 interviews**
  - **48 procurement contracts**
  - Between the Délégation Générale pour l'Armement (**≈ Depart. Of Defense**) and **18 contractors**
  - **Dates**
    - Period of signature: 1994-2005
    - **Medium-term contracts (5 years)**
  - **Average price: € 135 million**
  - Most of contracts were initially negotiated (77%)
  - **Diversity of equipment and of types of activity** (research, production, maintenance, global)
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## 1.2 Main economic features

- **Strong long term bilateral relations** between the department of defense and contractors
  - Foundation
    - Monopsonistic and oligopolistic market
  - Consequences
    - **Repeated transactions => possible to enforce informal agreements**
    - Cooperation. Developing partnership relations

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## 1.2 Main economic features

- Objective pursued by the DOD: competitive **autonomy of the procurement process**
  - Implications
    - Developing the defense industrial base
    - **Contracts are negotiated most of time**
      - No competition - International outsourcing (very) limited
- **Other features**
  - High financial stakes
  - Organizational and technical complexity
  - Significant uncertainty

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## 2. Relational governance

- 2.1 Informal contracts
- 2.2 Self-enforced agreements
- 2.3 => Relational contracts

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## 2.1 Informal Contracts

- **Decision rules apply although they are not stipulated in contracts nor in regulations**
  - The responsibility principle (section 3.1)
  - The hazard equilibration principle (section 3.2)

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## 2.1 Informal Contracts

- Explanation for informality
  - Constraint
    - **Lack of contractual abilities to govern complex transactions from a formal way**
  - Deliberate decision
    - Avoiding the lock-in effect
    - **Avoiding the signal (to the parliament) of potential price overruns**
    - **Confidence coming from equitable conditions of contract enforcement**
- Enforcement mechanism of informal agreements
  - Repetition of transactions

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## 2.2 Self-enforced agreements

- Partners solve their disagreements without resorting to third parties
  - The judge is not used to enforce contracts
    - **Suing is not a contractual strategy!**
  - Motivations:
    - Usual shortcomings in the court system (B. Arruñada)
    - **Classified information (technical specifications)**
    - **Informal agreements between the DOD and contractors => judges would fail to stick to the spirit of the agreed terms**
    - High financial stakes and specific assets => large self-enforcing range of contracts (Klein 96)

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## 2.2 Self-enforced agreements

- No control abilities from outside parties
  - Parliament
  - Cour des Comptes
- => **Private relations between the DOD and contractors**

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## 2.3 Relational contracts

- Defense procurement contracts: informal and self-enforced => relational contracts
  - Consequences:
    - Formal contracts are used as a general guide to be completed over time
    - **The explanation of contractual choices cannot be realized thanks to the analysis of formal contracts only**
      - Identifying and understanding informal decision making is fundamental in that perspective
    - Formal incompleteness but... not incomplete governance
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# 3. Risk allocation: relational but not incomplete decision making

- 3.1 The responsibility principle
- 3.2 The hazard equilibration principle
- 3.3 Discussion

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## 3.1 The responsibility principle

- Holmström & Milgrom 91
- When transaction parties are able to determine their relative responsibilities, they decide to allocate financial consequences of chocks to the partner responsible for their sources (Oudot, 06)
- 27 contracts are impacted in my dataset

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## 3.2 The hazard equilibration principle

- Williamson 85, Masten 88
- When transaction partners are unable to determine clear responsibilities, they decide to share financial consequences of adverse events 50-50 (Oudot & Ménard, 06)
- 8 contracts impacted in my dataset

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## 3.3 Discussion

- Incomplete formal contracts
- More complete informal agreements
- **Gap between rules of “the game” and their applications**
  - Necessary for practitioners to link their informal decision making with strict administrative rules

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# Conclusion

- Relational governance
  - Both implicit and self-enforced agreements
- Not incomplete governance
  - Decision rules apply without being stipulated in contracts nor in regulations
- Enforcement mechanism
  - Repetition of transactions
- Formal and informal agreements are complementary (rather than substitute) to govern transactions (Poppo & Zenger, 02)