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**PERFORMANCE OF THE CONTRACTUAL  
ARRANGEMENTS OF PUBLIC-PRIVATE PARTNERSHIPS:  
  
CASE OF RAILWAY CONCESSION IN TANZANIA.**

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## **List of Abbreviations.**

CCM	Chama Cha Mapinduzi (Party of the Revolution in Swahili)
DRC	Democratic Republic of Congo
GoT	Government of Tanzania
IFC	International Finance Corporation
MOID	Ministry of Infrastructure Development
PFI	Private Finance Initiative
PPA	Power Purchasing Agreement
PPIAF	Public-Private Infrastructure Advisory Facility
PPP	Public-Private Partnership
PSRC	Parastatal Sector Reform Commission
RAHCO	Reli Asset Holding Company
RFP	Request for Proposals
RFQ	Request for Qualifications
SOE	State-Owned Enterprise
SUMATRA	Surface and Marine Transport Regulatory Authority
TRAWU	Tanzanian Railways Association Workers Union
TRC	Tanzania Railways Corporation
TRL	Tanzania Railways Limited

## **Abstract.**

This thesis analyzes dynamics of Public-Private Partnership contractual arrangements and focuses on uncovering reasons of the disintegration (renegotiation and/or cancellation) of such contracts. It looks in detail at a specific case of a contractual arrangement of concessioning of the Tanzania Railway Corporation (TRC), a backbone of the corridor that links the landlocked Rwanda, Burundi and Uganda, as well as the eastern DRC and the hinterland of Tanzania, to the port of Dar es Salaam. This research first concludes that such widely acknowledged causes as information incompleteness and asymmetry (contract-related explanations) and opportunistic behavior and strategic alliance-making (non-contractual explanations) cannot fully explain disintegration of a particular contractual arrangement. It then builds upon a case study to extend existing explanations of contract failure and renegotiation by drawing on organizational and alliance theories and explains which characteristics of the institutional context make the detrimental effects of particular causes possible.

# 1. Introduction.

Much is said about development in terms of interconnectedness of the world, trade in goods and services, mobility of people. Hope and skepticism both characterize attitude of researchers, policy-makers and common citizens to the increasingly interlinked world. One of the processes contributing to this interconnectedness is the steady decrease in the cost of transport. As World Development Report 2009 specifies, transport costs have halved since 1970s (WDR, 2009: 175) and now contribute significantly less to the costs of final goods and services. This is mutually related with the surge in international and regional trade, an exchange in both similar and very different goods and services.

Investment in transport infrastructure was one of the major driving forces for transport cost decrease in most of the modes. Importantly, some of the transport modes function as natural monopolies, and rail services is the most prominent example. Data accumulated by PPIAF of the World Bank demonstrates that since 1990 there were 1099 projects with private participation in transport sector. Though evaluations of some of these projects highlighted limited success, the overall impact has been favorable as significant additional infrastructure investment has been generated by private sector participation.

This thesis will focus on the specific case of private participation in transport in East Africa. The case under investigation will be the contractual arrangement of concessioning of the Tanzania Railway Corporation (TRC), a backbone of the corridor that links the landlocked Rwanda, Burundi and Uganda, as well as the eastern DRC and the hinterland of Tanzania itself, to the port of Dar es Salaam, one of the biggest hubs on the East African coast.

Concessioning of TRC met limited success: the carried tonnage went even further down, contracting parties kept blaming each other for contributing to such a decline, calls for cancellation or renegotiation of the concession contract were voiced repeatedly. This thesis builds on the theories of contract incompleteness, information asymmetry and previous research on the causes of PPP contract renegotiation to analyze the interplay between contractual (formalized) and non-formalized causes of

a limited success of central railway concession in Tanzania. Apart from applying existing theories to a particular case, it contributes to the theory by drawing on the organizational and alliance theories to highlight the role of trust and to establish links between contractual and non-contractual causes of limited success of PPPs at different phases of the railway concessioning project. By limited success of a PPP contractual arrangement I will denote situations whereas contracts are renegotiated or cancelled, i.e. the cases when the contracts were not preserved in their original form.

### **1.1. The Aim**

Overall, the aim of this research is to analyze reasons of the disintegration of PPP contracts. More specifically, this thesis first aims to uncover whether such widely acknowledged causes as information incompleteness and asymmetry (contract-related explanations) and opportunistic behavior and strategic alliance-making (non-contractual explanations) can fully explain disintegration of a particular contractual arrangement. It then aims to extend existing explanations of contract failure and renegotiation by drawing on organizational and alliance theories and explaining which characteristics of the institutional context make the detrimental effects of particular causes possible.

The purpose of this research is both to contribute to the theoretical analysis of the PPP deals and to indirectly support practitioners' decision-making by making the analysis generalizable beyond the case of TRC concession.

I put forth the following hypotheses to be tested to guide this research:

1. Incompleteness and asymmetry of the contract-related information lead to disintegration of a PPP contract due to changes in the environment and by allowing for detrimental opportunistic behavior of the contracting parties.
2. PPP contract disintegration can be explained better if contract is viewed as a multi-stage process where the dynamics of trust in a particular context plays a significant role.

These hypotheses were derived from the review of the theoretical literature, as I will demonstrate further in this paper. Though they are not opposite to each other, a finding that factors mentioned in the first hypothesis leave some share of the

contractual arrangement disintegration unexplained leads one to test the second hypothesis.

## **1.2. Outline of the Thesis**

The paper is organized as follows. First, I give a brief overview of the recent trends of reforms in Tanzania, to which promotion of private participation in infrastructure is tightly related. I also summarize the background of the transport sector in Tanzania and East Africa – with specific emphasis on railway transport – to put railway concessioning in the context of other developments in the sector. Secondly, I outline a theoretical framework of this research. I take a look at the theories of information incompleteness and asymmetry that explain contract-related causes of PPP renegotiation. I also draw on the studies of such non-contractual causes of PPP renegotiation as opportunistic behavior of the parties. I then add a new aspect to the theoretical framework by pointing out the role of trust and drawing on organizational and alliance theories. Thirdly, methodology most fit to consider the proposed research questions will be described. This will involve specifying the practical steps taken to collect the data used to test the hypotheses.

Fourthly, empirical material on the case of TRL will be presented and analyzed. The discussion will focus on two broad factors contributing to the limited success of the concession: (i) unavoidable contract incompleteness and adversary effect of the matters external to the control of the parties involved, (ii) choices made by the contracting parties outside the boundaries set by contract arrangements. Uncovering the interplay between these two groups of factors as the concession progressed from one stage to another will be the major focus of the research. I will then conclude by summarizing major findings and relating those to the theoretical debate and gaps on the matter and by highlighting avenues for further research.

## **2. Background**

In this section I will describe the historical and institutional context in which the TRL concession is taking place. Current and previous institutional frameworks will undoubtedly have an impact on the ongoing processes in the country. As Tanzania is still undergoing transformations from the decades of socialism, the role of state institutions is in flux and understanding the dynamics of the political and economic transformations is crucial for testing the hypotheses put forth in this paper. Indeed, as the state is one of the partners in the PPP deals, a thorough understanding of the political and economic framework is important for the discussion of strategic alliance-making, opportunistic behavior and the dynamics of trust.

### ***2.1. Tanzania: Political Transformations.***

Tanzania began its political transformation in the beginning of 1990s with the introduction of the multi-party competitive political system. At the same time, with the Zanzibar declaration it has started economic reforms oriented towards greater private participation. Overall, the GoT embarked on a number of political and economic reforms that encompassed public sector, state-owned enterprises, party and electoral systems to name just several areas. Costello builds on Przeworski's classic conclusion on the necessity of the viable alternative for the transformation to occur (1986) to maintain that existence of the strong bureaucratic elite served as a facilitating force over the catalytic effects of the financial turmoil of the 1980s. (1996: 123) Moreover, Costello claims that bureaucracy became an important player in political and economic affairs of Tanzania emerging from being subsumed by the central government dominated by the ruling CCM. (1996)

Two considerations related to the background of Tanzania prior to reforms deserve special attention. Firstly, bureaucracy has been sidelined by the transformation of Tanganyikan African Association (TAA) into the Tanganyikan African National Union (TANU) under the leadership of Mwalimu (Teacher) Julius Nyerere. Being prohibited from participating in TANU, the bureaucratic elites found themselves united through the Tanganyikan Federation of Labor, a national umbrella union organization. (Costello, 1996: 125) Ties between government officials and labor



leaders are weaker now than in the 1960s and 1970s but are still significant (Kamugisha, 2009)

Secondly, technical competencies of the bureaucrats allowed it to demonstrate its importance for the state affairs by often being unresponsive to the “amateurism of the of party officials” (Hopkins, 1972: 114-15) Similar attitudes are present among the senior career bureaucrats towards current-day politicians and political appointees in the ministries, as described by the numerous interlocutors, interviews and direct observation. Indeed, the political appointees like Ministers – being MPs of the ruling CCM – and Permanent Secretaries (PSs), keep controlling the key resources for the political and economic decision-making (Costello, 1996: 127). In its turn, CCM views such groups as the bureaucratic elite as one of the party fractions (Kelsall, 2002: 613).

These two historical determinants point towards difficulties in maintaining cohesion within the state apparatus as the reforms progress. Indeed, practices of land-grabbing, export-import schemes and other means of enrichment involved a number of the bureaucrats at the high levels of government, as reported by Kelsall (2002). Moreover, as a study of transformation of Central and Eastern European economics showed, the extent of political reform has a positive influence on the impact of economic reforms on infrastructure development (Feinberg and Meurs, 2008: 237). In case of Tanzania, the extent of political reform – operationalized by Feinberg and Meurs as the broadness of the political alliances and the attained depth of anti-corruption struggle (2008: 241) – was seriously delimited by the internal strife within the political elite.

Similar trends characterize economic reforms and, specifically, privatization agenda. Hewitt (1999) demonstrates that despite general acceptance of the private participation in the economy as the way forward, the tensions between agendas and actions of the government, private sector and the donor community delimited the progress of economic reforms. Essentially, the studies show that the GoT was not ready for “its new role as a market/non-market facilitator” (Wield, n.d.: 6) and that the capacity of the state has been detrimentally diminished by the long economic downturn of the 1980s. Moreover, the reform agenda was mandated and stirred by the Government, dominated by CCM, while a weakened bureaucratic apparatus was left

fearing the loss of influence with the diminishing public sector. Long-lasting cleavages between the politicians and the bureaucrats within the government structures were not specifically addressed as an area of concern and, as we will see, has had an effect on implementation of economic reforms.

## **2.2. Tanzania: Privatization Agenda.**

Despite these limiting factors, the economic reforms progresses with an impressive pace over the 1990s and 2000s. As the World Bank report on the Privatization Impact Assessment for the Infrastructure quotes, while “by the end of 1980s, Tanzania had around 400 state-owned enterprises (SOEs or parastatals), many inefficient and loss-making”, “by the early 2000s, the privatization of manufacturing and commercial parastatal enterprises was virtually complete.” (World Bank, 2005: 6) It has been recognized to be an overall success in the non-infrastructure sectors. A Parastatal Sector Reform Commission (PSRC) was formed in the early 1993 with a mandate to privatize or liquidate loss-making state-owned enterprises. A total of 383 loss-making enterprises were specified for divestiture when PSRC was formed; by the beginning of 1998 about half of these enterprises were “disposed off either through privatisation or liquidation” (Hewitt, 1999: 385).

However, Hewitt also underscores that the formation of PSRC was not backed by the clear understanding of the reasons for privatization altogether (1999: 385). This is echoed by Mr. Karavina, who has been working with PSRC for about five years in the later 1990s and beginning of 2000s. His view is that privatization effort was largely donor-pulled and the GoT lacked understanding of the need for privatization and the potential pitfalls involved; he adds that it has been an undertaking that aimed to minimize losses and cut costs. (Karavina, 2009) The effects of such attitudes are especially visible in relation to the infrastructure sectors.

By 2000 infrastructure enterprises remained heavily dependent on government support and required a restructuring program to encompass them as well, which is what was kick-started by the President of Tanzania in the early 2000 and further reaffirmed in 2005. (World Bank, 2005: 7) Indeed, infrastructure enterprises, after the policy change towards private sector promotion, were largely loss-making, though

operating with the assistance of the government subsidies and support programs (World Bank, 2005: 8-9) and reform was needed badly.

By 2005 divestiture and privatization of infrastructure enterprises met limited success, at least in part of the significant required financial injections. This, in its turn, is tightly related to the key characteristic of the privatization and divestiture policies in general and PSRC actions in particular. Since the privatization was viewed as a cost cutting action, enterprises specified for divestment were, firstly, cut off from the most of life supporting government subsidies and transfers and, secondly, prohibited from receiving investment finance from the government. This is reflected in the budget structure of the mid to late 1990s when the development component of the state budget started dwindling and incorporating more and more hidden recurrent expenditures. Such move was perfectly in line with an overall aim to minimize losses and cut costs of running the loss-making enterprises and stemmed from the deficit of operational finance. However, it has also had consequences for the capital maintenance and formation in the highly capital-intensive infrastructure enterprises. This had implications for the TRC, an entity under investigation in this paper. Mr. Tito claims that between 1996, when TRC was specified for divestiture, and 2007, when it was finally concessioned, the enterprise received just about enough financial support from the government to subsidize its loss-making third class passenger services but not enough to maintain and develop the assets at hand (Tito, 2008).

Though very often mentioned by various stakeholders, the studies of the privatization process in Tanzania surprisingly rarely mention a history of capital underinvestment as the limiting factor. Though it has obviously played an important role in limiting the attractiveness of the enterprises for private actors, it might not be as politically convenient to address as the 'softer' issues of institutional environment or even instances of corruption. This paper makes a contribution by addressing this issue to a more significant extent than the previous studies

### ***2.3. Transport Corridors in East Africa.***

Concessioning of the TRC needs to be put not only in the context of political and economic reforms of the 1990s and 2000s but also viewed with a consideration of its own specific business environment. As the railway transport is an essential backbone

of transport corridors, I will briefly outline the past and current conditions of transport corridors and trade flows in East Africa.

Overall, freight transport in East Africa serves such countries as Tanzania, Kenya, Uganda, Rwanda, Burundi, DRC, Malawi and Zambia. All of them, except for the last two, are the markets than can be served effectively by the Tanzanian Central Railway Line and Central Transport Corridor in general. At the same time, Northern Corridor that links a Kenyan port of Mombasa to the hinterland by rail and road is a powerful competitor. Generally, freight transport in the region is characterized by a two-fold kind of competition. On the one hand, the competition is between such modes of transport as road and rail within a particular corridor. On the other hand, the competition is between the corridors that are linked to two different ports on the East African coasts – Mombasa in Kenya and Dar es Salaam in Tanzania. It is intuitively clear that intra-corridor competition between modes impacts the inter-corridor competition (Please, refer to Appendix 1 for a map of railway lines in the region). Such connection between different types of competition has not been addressed much in general or for the case of East Africa; it is a promising avenue for future research, especially in what has to do with the impacts of the railway concessioning projects. Additionally, inland waterways and lake transport only recently started receiving due attention from scholars and practitioners. (CDC, 2008)

Several considerations pertaining to the freight transport business environment are of importance for this paper. Firstly, condition of infrastructure along both Northern and Central transport corridors leaves much to be desired. Recent rehabilitation and upgrading of the road networks both in Tanzania and Kenya – often through donor-supported projects and programs – was not matched by similar advances in rail transport. This has impacted intra-corridor competition and, plausibly, inter-corridor one as well.

Secondly, a large portion of demand for transport services is inelastic by cost of transport. This is manifested by the presence of ships outside ports of Mombasa and Dar es Salaam even at times of severe port congestion that leads to financial losses of the shipment companies owning vessels awaiting berthing. Essentially, the freight forwarders and transporters transfer higher costs of transport and monetized risks

associated with it to the end consumers. Inelasticity demonstrates that there is a significant scope for intra- and inter-corridor price competition. Because of such fierce expected competition, as well as due to the fact that transport services are highly divisible, one would expect predictions of allocation of freight between corridors and between modes based on prices of the services to be close to the actual figures. Preliminary calculations hint that this is not the case, which could yield a significant scope for research. Effects and processes of restructuring railway services can be one of the contributing factors.

### **3. Theory.**

In this section I will present and discuss theoretical perspectives on the major concepts and causal relations addressed in this paper. After revisiting the history of research and practice in the sphere of PPPs and reaffirming the non-homogeneity of the PPP arrangements, I will critically discuss several widely acknowledged causes of PPP contract renegotiation and cancellation. This will allow me to find openings for further research and set the ground for empirical investigation of a particular case of Tanzanian railway concession and relating it to general discussion of the causes of PPP contract disintegration.

#### ***3.1. PPP: a Particular Kind of a Contractual Arrangement.***

The term ‘Public-Private Partnership,’ or PPP, has emerged after a significant practical experience has been accumulated in cooperation between public and private sectors. The initial stages of what now came to be called ‘PPPs’ were dominated by focus on development of urban infrastructure and power supply. Wettenhall (2005: 2) cites a Reagan-era publication that investigated “imaginative partnership between business and government... [to] ... to save the cities” (Brooks, Liebman and Schelling, 1984). While efforts to provide infrastructure were underway in the USA, the terminology was so blurry as to claim that there was no single accepted term. Power Purchasing Agreements (PPAs) became prominent in the USA, a setup under which the government pays the private partner for the electricity supply. Availability charges were paid for the provision of the electricity generation capacity and user charges – per unit of power consumption by the end users.

In the UK the PPAs became popular in the 1990s, quickly spread to such other sectors as transport, water and urban services and acquired a name of ‘Private Finance Initiative’ or PFI that was replaced by New Labor government in the UK with a “friendlier sounding ‘Public-Private Partnerships’ (PPPs)” (EIU 2002). PPPs mushroomed in many forms and departed from the initial arrangement of the government paying the private party for the provision of the services. Such arrangements as Build-Operate-Transfer (BOT), Build-Operate-Own (BOO), Build-Finance-Operate-Transfer (BFOT) became prominent. Concessioneering of the public

enterprise to a private firm for a combination of fees is a relatively newer form of a PPP arrangement, the one that will be under investigation in this paper.

There are many ways to conceptualize PPP arrangements against traditional and, thus, more understandable setups. Often PPPs are “frequently viewed as a derivative of the privatization movement ... of the 1980s” (Linder, 1999: 35) thus presenting a new form of the private involvement in the public domain. Starr (1990), on the other hand, highlights how the idea of ‘partnership’ helped to blur the border line between spheres of public and private (and, essentially, the concepts themselves), a division made sharper by the privatization frenzy of the 1980s. Linder describes six widespread ways to think of PPPs: as management reform, as problem (of public service delivery) conversion, as moral regeneration, as risk shifting, as restructuring public service, and/or as power sharing. (1999)

As a uniform and unambiguous use of the term is problematic, for the purposes of this paper I propose to use the following definition of the PPPs proposed by the Institute for Public Private Partnerships (IP3):

Public-Private Partnerships (PPPs) are a form of legally enforceable contract between the public sector and private sector, which requires new investments by the private contractor (money, technology, expertise/time, reputation, etc.) and which transfers key risks to the private sector (design, construction, operation, etc.), in which payments are made only in exchange for performance, for the purpose of delivering a service traditionally provided by the public sector.

(IP3 2008)

This definition underscores that PPPs are, essentially, contractual arrangements, viability of which will be the focus of this paper. The definition also incorporates concessions, though they are one of the many forms of a PPP, as demonstrated below on Diagram 1. Concessions are characterized by a longer duration of contracts (20-30 years), large investment requirements for the private party, transfer of many risks to the private sector, and reversal of assets back to the state after the completion of the contract.

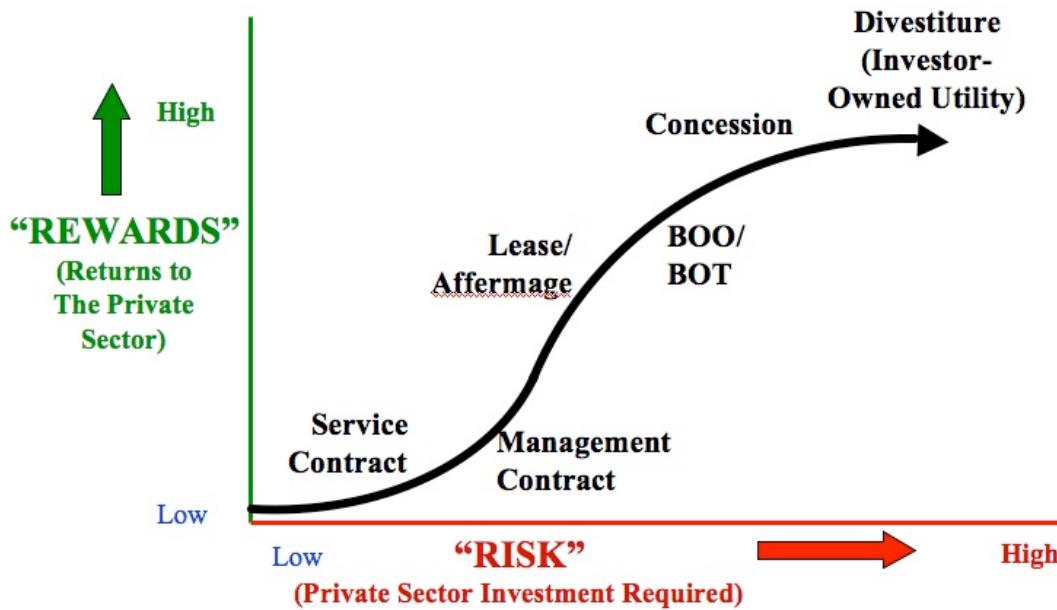


Diagram 1: Typology of PPPs by Investment/Risk and Rewards.

Source: IP3, 2008.

To conclude, both practical experience and academic research demonstrate convincingly that, though PPPs are not a homogenous category of public-private interaction, they are best conceptualized as contractual arrangements between public and private entities. Differentiation is possible in terms of allocating financial and managerial responsibilities, risks and payoffs.

### **3.2. Viability of a PPP Depends on Both Contract and Context.**

Vives, Benavides and Paris (2006) depart from acknowledging that PPP arrangements are heterogeneous and employ theoretical considerations to present a continuum of financial structures available for the infrastructure PPP projects in particular contexts. The authors draw on theoretical considerations and previous research to demonstrate convincingly that for PPP projects “different structures ... must be devised to encompass the relative participation of each party” and stress “the need to match these participations to project characteristics, local context and financial arrangements.” (Vives, Benavides and Paris, 2006: 2)

Though avoiding the use of the apparatus of institutional economics, the authors extend the seminal work of Acemoglu, Johnson and Robinson (2001) which concludes that institutional setup doesn’t simply matter but is contributing to the success (or failure) of a particular undertaking or development at large. Essentially, Vives, Benavides and Paris (2006) show that a context, approximated by a number of



parameters, presents a set of viable PPP project modality options that can be extended by application of tools, availability and practicality of which is also conditional on the context. Importantly, the tools become a part of the PPP deal and are reflected in the contractual arrangement. The contribution of the authors is that both the particular contractual arrangement *per se* and its relation to the context contribute to the success or failure of the PPP undertaking.

Additional theoretical considerations are necessary before I proceed with analysis in precisely this manner. In the next section I will consider previous research of the instances and causes of PPP contract renegotiation. Key factors contributing to contract renegotiation and cancellation will be considered and limitations of the analyses will be underscored.

### **3.3. Causes of Disintegration of Contracts.**

Experience of infrastructure restructuring through PPPs is mixed. Guasch, Laffont and Straub conclude that in Latin America “over forty percent of concessions appear to be renegotiated, and sixty percent of those within three years of the award of the concession” (2003: 5), excluding the telecommunication sector. Though no detailed research has been completed for other regions, fragmentary evidence suggests little variation. Specifically for the railway sector, Thompson (2003) concludes that many undertakings across the world taught policy-makers and practitioners some valuable lessons about the factors influencing viability of railway restructuring. In particular, he highlights that contractual arrangements need to be flexible enough to account for changes in circumstances at later stages. (Thompson, 2003: 347) Overall, Thompson and other researchers point at the unavoidable incompleteness of any contractual arrangement while they emphasize the role of the quality of a specific contract in what has to do with asymmetric information and opportunistic behavior. (Thompson, 2003; Guasch, Laffont and Straub, 2003, 2005) Both contract incompleteness and consequences of possible information asymmetry deserve a more detailed theoretical overview in relation to contract formulation and renegotiation.

#### **3.3.1. Contract Incompleteness: an Inevitable Cause of Renegotiation?**

As Maskin and Tirole highlight, “there is no well-accepted incomplete contracting paradigm” (1999: 83). However, a number of scholars highlight the importance of

contract incompleteness in general (Anderlini and Felli, 1994), for the restructuring of public enterprises in particular (Sappington and Stiglitz, 1987; Bos, 1996) and specifically for PPP arrangements (Hart, 2003). Analyses at different levels tend to all focus on the nature of contracts rather than on the quality of a particular contract or its implementation.

Overall, contract incompleteness originates from the impossibility of envisaging all possible states of the world and, consequently, reflecting on them in a contractual arrangement. As Anderlini and Felli put it, “intuitively, it is clear that not every agreement can be written in a contract” (1994: 1086). Two broad approaches to conceptualizing contract incompleteness emerged within a field of property and control rights.

First, an approach from the side of transaction costs follows seminal contributions of Williamson (1975, 1985). In line with this approach, Segal points out that “*in a complex environment*, all four ... ‘transaction costs’ may be important ingredients in explaining contractual incompleteness” (1999: 74 emphasis author’s). Here Segal refers to four types of transaction costs specified by Tirole (1994) – unforeseen contingencies, writing costs, enforcement costs and renegotiation. The first three of these four types can be easily presented in monetary terms. The transaction cost of the possibility of contract renegotiation is a more complex case related to the bounded rationality of economic actors, and, specifically, to the choices they face. Segal concludes that

Given the considerable cost of administering complicated contractual message games (“formal communication”), the parties may prefer not to write the renegotiation game directly in the *ex ante* contract, instead leaving the option of renegotiation (“informal communication”) open. Thus, the “transaction costs” of formal communication may help explain why contracting parties would *strictly* prefer to write an incomplete renegotiable contract, rather than a complete non-renegotiable one.

(Segal, 1999: 74 emphasis author’s)

Two points can be highlighted here. Firstly, notice the ‘game’ terminology used by Segal. This finds reflection in other studies of incomplete contracts (see Bernheim and Winston, 1998 for a representative discussion). Secondly, a notion of ‘informal communication’ features in the qualitative discussions of management issues

pertaining to contract implementation (Muller and Turner, 2005) and corresponds to the concept of ‘signaling’ in influential works of Anderlini and Felli (1994) and Spier (1992). This also points to the role of trust as a factor decreasing the costs of the risks of relying on informal, as opposed to formal, communication. The overall conclusion of this transaction costs approach to dealing with contract incompleteness is that renegotiation cannot be ruled out and trust-related relative cheapness of informal communication gives incentives to parties to leave unforeseeable conditions for future deliberations.

On the other hand, Maskin and Tirole (1999) analyze whether it is necessarily so that transaction costs are relevant for describing behavior under incompleteness of information. Their conclusion is that a very plausible ability of economic actors to link future payoffs to future states of the world (even if these states of the world cannot be described in full) makes transaction costs limitations to contract drafting irrelevant. (Maskin and Tirole, 1999: 87 – 90) The limitation that the authors point out is the possible lack of incentives to *truthfully* describe the physical state of the world *ex post* (Maskin and Tirole, 1999: 84), which also relates to the level of trust between the contracting parties. Moreover, the role of information asymmetry – and not just incompleteness – becomes evident if one considers parties’ incentives to truthfully disclose available information.

### **3.3.2. Information Asymmetry, Opportunistic Behavior and Strategic Alliances: Avoidable Sources of Renegotiation?**

A vast body of literature addresses the role of the asymmetry of information in general and specifically for processes of ownership change. Sappington and Stiglitz (1987), for instance, address the role of information and incentives in the debate on whether public or private provision of goods and services should be preferred. They highlight that better information on production technology makes private producers more risk averse than government and more prone to “renege on the contract rather than provide services” (Sappington and Stiglitz, 1987: 573). The authors propose to go beyond a clear distinction of private vs. public spheres and remind that possibility of adequate industry regulation, for instance, can serve to promote risk sharing and trespass the damage done to trust by asymmetric information.

Hart (2003) arrives to a similar conclusion for the specific case of the use of PPPs for the bundled or unbundled tasks of construction and service. Essentially, Hart's conclusion is that "PPP is good if the quality of service can be well specified in the initial contract...whereas the quality of the building cannot be" (2003: C74). This conclusion points towards the necessity of establishing a trustworthy regulator that is immune from pressure from either of the parties of a particular contractual arrangement. This also points to the necessity to draft contracts in a way that puts "emphasis on the conditions that would guide [serve as grounds for] subsequent renegotiations." (Thompson, 2003: 346)

In particular, practical evidence shows that failure to achieve performance indicators is the single most important ground for contract renegotiation. This, as well as Thompson's findings, is echoed by Trujillo, Quinet and Estache (2002) who made a significant contribution to the discussion of the process of transport privatization and PPP arrangements as well. Their research focuses on the demand forecasting in transport privatization, the core element in payoff forecasting and risk sharing. The authors demonstrate that erroneous demand forecasting is not a rare phenomenon, differentiate between different causes of it and specifically highlight the role of information asymmetry, promoted by the multiplicity of actors involved. Erroneous forecasting and evaluation can lead to contract renegotiation as the expected payoffs are not realized.

Of special importance is the authors' conclusion that "several actors are strategically induced to play overshooting or undershooting vis-à-vis the most probable forecast" (Trujillo, Quinet and Estache, 2002: 329). This, essentially, means that accounting for possible information asymmetry is sometimes less rational than engaging in strategic behavior based on a false information. The same logic can be applied to such other parameters as the condition of the assets or qualifications of the labor force, both of which impact forecasted payoffs. While scientific uncertainty is not likely to be of the same importance as for demand forecasting, opportunities for strategic behavior are also clearly there. Renegotiation of a contract based on deliberately erroneous information can happen if the strategic alliance disintegrates.

The role of opportunistic behavior in contract renegotiation has been highlighted not only by Trujillo, Quinet and Estache (2002) but by others as well. In particular, Guasch, Laffont and Straub (2005) consider government-led renegotiation of concession contracts and highlight that opportunistic behavior of the contracting parties can lead to exacerbation of information asymmetries, which, in its turn is related to erroneous forecasting of payoffs. Moreover, Guasch, Laffont and Straub demonstrate that “if firms have private information and anticipate opportunistic behavior by the government, for example because it is not able to commit not to renegotiate, they may want to hide their information to protect future rent.” (2005: 5) Though not explicitly stated in their earlier work on firm-led concession renegotiation (Guasch, Laffont and Straub, 2003), the same logic can be applied the other way around. An obvious opportunity for strategic behavior is presented by scientific uncertainty and information asymmetry pertaining to demand forecasting.

Indeed, alliances between government actors and bidders are more likely regarding demand forecasting or asset valuation if either of the two conditions is satisfied. Firstly, if contract specification ties payoffs to the amount of service or good production, overestimation of demand and value of assets is a rational behavior for the government. Secondly, if private bidder faces stiff competition for the deal it finds attractive it can also find it rational to collude with the government’s overestimation of demand and assets. Private actor’s rationale can be based on the expectation of renegotiating the deal at some point in the future “once an enterprise has been granted a concession ... and the bidding competitors are gone” while “informational advantage” is accruing to the private bidder (Guasch, Laffont and Straub, 2003: 4). The authors conclude that the effectiveness and independence of a regulator can effectively prevent detrimental collusions between contracting parties. (Guasch, Laffont and Straub, 2003: 4).

Apart from this conclusion, specificity of PPP deals hints at another possible way to control for opportunistic overestimation and overvaluation and strategic alliances. Since PPP deals are heavily debt-reliant, the involvement of commercial banks in the financing of the PPP deals is common. (See Diagram 2) The interest of the commercial banks is to ensure repayment of the loan by the Special Purpose Vehicle, a company of limited liability formed specifically for a particular PPP project. Hence,

the involvement of the commercial lenders in project preparation, evaluation and due diligence is likely to be high, while their incentives for forming strategic alliances is low if existent at all. (IP3, 2008)

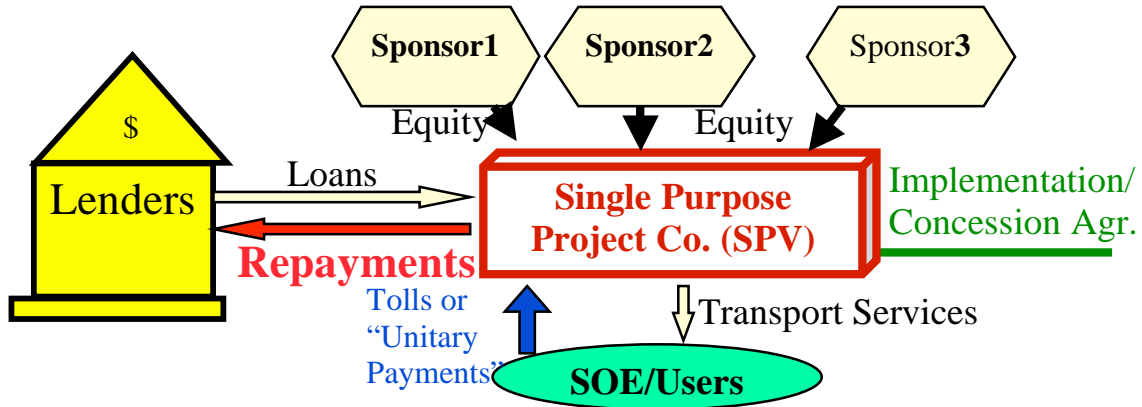


Diagram 2: Limited Recourse “Project Finance”  
Source: IP3, 2009.

Both ways to control for opportunistic bidding, erroneous forecasting and valuation and strategic alliances are, however, focusing on a particular stage of a PPP project, namely at project preparation. Considerations pertaining to information incompleteness and asymmetry are also characterized by such focus on a particular project stage. Thus, so far I have presented theoretical considerations that are rather static and take a look at only one stage of project at a time.

Such static view can explain rather convincingly why contract renegotiations and cancellations happen. However, one could also be interested in what impacts the chances of renegotiations. Two considerations can help us supplement theoretical grounds of this paper with a more dynamic view. First of all, there are cases of concessions all over the world that were not renegotiated or cancelled despite opportunistic bidding, overestimation of demand and value of assets, disintegration of strategic alliances or any of these combined. Hence, there is a need to look for additional explanations. Secondly, processes at different stages of project life can be related to each other in such ways that negative impacts of all abovementioned actions are mitigated. There is a need for a dynamic view and, especially, theoretical considerations that consider linkages between stages of project life.

### **3.4. Partnership: A Multistage Process.**

Inter-organizational collaboration both in business and non-profit sectors has been a subject of much research within organizational theory and management studies. For instance, Osborne (2000) employs a broad understanding of PPPs and compiles a number of studies that focus on both for-profit and non-profit organizations. A contribution from Osborne and Murray (2000) originates from the earlier studies of non-profit sector but extends to a more general case of PPPs.

The authors build on Murray's (1998) understanding of the "collaborative process as multi-phased series of stages" (Osborne and Murray, 2000: 71). They advocate for identifying five stages: the pre-contact phase, the preliminary contact phase, the negotiating phase, the implementation phase and the evaluation phase. (Osborne and Murray, 2000: 71) Each of these phases has unique characteristics but the general claim is that processes at later phases are dependent on the processes and outcomes of the earlier phases.

Other studies of organizational cooperation identify comparable phases of partnerships. This, for instance, Ring and Van de Ven (1994) follow in the steps of Commons (1950) and use the analytical framework of negotiations, commitment and execution stages. They go further and highlight that the assessment of how successful the cooperation is at each stage depends on the actors' perception of efficiency and equity (Ring and Van de Ven, 1994: 93-94). They underscore that the efficiency and equity go beyond economic definitions of the terms and incorporate sociological "meaning of indebtedness." (Ring and Van de Ven, 1994: 94) Both Ring and Van de Ven (1994) and Osborne and Murray (2000) link emergence and development of partnerships to the dynamics of the interplay between formal and informal relationships. Thus, Ring and Van de Ven observe that institutionalization of a relationship is reflected in three processes: "(a) personal relationships increasingly supplement formal role relationships, (b) psychological contacts increasingly substitute for formal legal contracts, and (c) ... formal agreements increasingly mirror informal understandings and commitments" (1994: 103).

The outline of such dynamics is especially illuminating if linked to the related processes of building trust and preventing opportunistic behavior. On the one hand,

higher level of trust among parties cuts down the transaction costs and minimizes expenses on formulation and enforcement of the formal contracts. On the other hand, as Granovetter (1985) highlighted, higher levels of established trust also present opportunities for its abuse and opportunistic behavior. Theoretical model built by Ring and Van de Ven (1994) and upheld by Osborne and Murray (2000) predicts that another cycle of interpersonal communication in negotiation, commitment and execution is sometimes needed to rebuild trust damaged by malfeasance.

Other authors confirm the existing interplay between contractual and relational governance of partnerships specifically for the cases of PPPs. (Zheng, Roehrich and Lewis, 2008) The authors use two PFI cases to demonstrate that “relational and contractual mechanisms are indeed complimentary forms of exchange governance” of partnership (Zheng, Roehrich and Lewis, 2008: 52). Moreover, they demonstrate that relational dynamics affect contract perception and implementation at subsequent project stages. In particular, Zheng, Roehrich and Lewis conclude that “relational assumptions, experiences and intentions of all parties appear to actively frame whether the contract and contracting process is interpreted as a sign of distrust or a written manifestation of commitment.” (2008: 52) While criticism can be extended that the authors only deal with processes in developed markets, their conclusions can be extended to the contexts of developing countries.

Weihe (2006) also takes a look at PPP arrangements and the underlying forces forging alliances. His perspective is driven by an extensive literature on organizational alliances and also builds on Ring and Van de Ven (1994). Essentially, Weihe claims that “social dynamics and the way partnerships evolve over time ... are significant for the end result – i.e. whether or not collaborative advantage is achieved.” (2006: 5) He also relates it to the case of PPPs. Specifically, Weihe demonstrates that “the way cooperation processes evolve over time determines the way in which the involved actors continuously evaluate and re-evaluate their relationship,” (2006: 20) while results of such continuous evaluation can trigger the downward or upward spiral of the collaboration identified by Ring and Van de Ven (1994). This relates to more general findings of Doz, who claimed that it is neither just initial conditions, nor only the ongoing interaction but both of them that define the success of the partnership (1996: 81).



### ***3.5. Towards Analytical Framework.***

Thus far I have reviewed the existing literature to set a theoretical basis for this paper. Before I proceed to consider methodology of this paper and present my empirical findings, a summary of the theoretical conclusions and how they translate into an analytical framework of empirical analysis would be helpful.

First of all, we can conclude that PPPs are best conceptualized as contractual arrangements of a particular type. They are often formed in the conditions also characteristic of when privatization of state-owned enterprises happens. Moreover, success of PPP arrangements depends on both the quality of contractual arrangement and the context in which PPP is happening. Secondly, as it is clear that renegotiations and cancellation of PPPs are not uncommon, I have outlined to broad lines of thought on the causes of the PPP renegotiation. On the one hand, inherent contract incompleteness contributes to the likelihood of PPP renegotiation. On the other hand, even though it appears feasible to avoid or mitigate much of contract incompleteness, the parties might rationally choose an incomplete contract, to leave some issues for future deliberations and to enter in a strategic alliance. These theoretical considerations relate to the first hypothesis put forth for this paper. Indeed, in the empirical analysis I will test whether inevitable contract incompleteness or presence of information asymmetry can explain the contract disintegration.

However, willingness to choose an incomplete contract or engage in a strategic alliance depends on the level of trust between the contracting parties. While information asymmetry makes opportunistic behavior possible, the extent and consequences of (limited) information disclosure also depend on the level of trust between the parties. Lastly, trust is best looked at from a dynamic perspective that considers all project stages. This view departs from taking PPP arrangements as impersonal business arrangements and argues for looking at them as more personalized partnerships. Moreover, stages of a particular PPP arrangement need to be related between themselves and to the wider institutional context. Theoretical reflections on the role of trust and its dynamics throughout the stages of the project constitute the grounds to address the second hypothesis of this paper. In the empirical analysis I will look at the dynamics of trust between the contracting parties and relate

it to such factors as the impact of information incompleteness and the performance of strategic alliances.

Overall, such a way of tying two hypotheses through a single case helps link two under-connected theoretical fields to each other, and this constitutes a theoretical contribution of this paper. Establishing such a link traces back to the seminal embeddedness approach of Granovetter (1985), who aimed to trespass the ‘undersocialized’ explanation of economic action without ‘oversocializing’ it. Weihe conceptualized interplay between relational and formalized contractual factors of partnership success in his desk review of prior research (2006) as presented on a Diagram in Appendix 2. Though Weihe’s model (2006) resembles closely what this paper is guided by, his conclusions are tested on a particular case (something his research is critically short of) and enhanced in this paper for a wide case of PPP arrangements.

Structure of the empirical analysis follows the two hypotheses and associated theoretical framework(s). Indeed, as the performance of PPP contractual arrangement is dependent on the context, the background of the railway performance is reviewed. Motivations for concessioning will be explored and related to the general background of political and economic transformations of Tanzania. I will then analyze how the concession deal was prepared and structured with attention paid to (a) signs of deliberate engagement in an incomplete contract, strategic alliances or opportunistic behavior and (b) the roles of various actors. This will set the grounds for testing the first hypothesis as I will analyze in depth the initial stages of the concession and the disputes and disagreements that accompanied it.

As I will progress with the empirical analysis of the concession process, the contribution of an additional perspective on the causes of contract renegotiation and/or cancellation will become more apparent. Dynamics of trust will take the center stage at this point and will also be used to explain what has been observed at the earlier stages. I will test the second hypothesis by providing additional explanations from the point of view of trust dynamics for how and why concession contract renegotiation and cancellation were on the agenda. Value added of alternative

explanations, as well as the linkages between them, will constitute the essence of this paper.

## 4. Methodology.

Methodological considerations of this paper are tightly related to the hypotheses, underlying general theory and the particularities of the phenomena under investigation. As the hypotheses deal with the causes, mechanisms and dynamics of a PPP contract disintegration, the primary unit of analysis is the contractual arrangement. Of course, this is not limited to the contract as a document *per se* but rather goes all the way to the context surrounding the contractual arrangement and formal and informal relations that constitute an integral part of it.

Essentially, heterogeneity of the contractual PPP arrangements and their relation to context demonstrate that there cannot be a blueprint for a design of partnership incentive structure through a PPP contract. Methodologically speaking, such heterogeneity of the PPPs and their connection to a context implies that the best way to investigate a contract is an in-depth case study. Indeed, Yin prescribes the use of case study when the research question is that of *why*, the focus of the study is on the current events that can hardly be manipulated (1994: 9) and “the boundaries between phenomenon and context are not clearly evident” (1994: 13). Case selection, collection of empirical material, its reliability and limitations should be considered in more detail.

Selection of an illustrative case was rather straightforward. First of all, the concession deal was still in its first year when the study commenced and, thus, had a lot of the processes visible and ‘in-the-making.’ Such time frame allowed access to information and people who have participated in the preparation of the deal. Secondly, the general perception was that the contractual arrangement was disintegrating. This eased case selection – though operationalization of ‘disintegrating’ was still needed – and pointed towards practicality of the research. Lastly, data collection was facilitated by author’s involvement in the process as a professional. This, of course, made it necessary to counter some possible constraints on validity and reliability of data.

Collection of valid and reliable data involved literature and document review, repeated semi-structured in-depth interviews with key actors, site visits and analysis of written internal and public documents. Literature review covered considerations of

the scholars of a broad political spectrum. This was crucial since the PPPs, change in ownership form and reforms of parastatals are all topics subject to ideological battles. Apart from that, several key documents served as the departure point – concession agreement, shareholders’ agreement, and related project appraisal documents of the World Bank and IFC.

Interviews were conducted with the key informants: chairpersons and managers of the TRC and TRL, government officials, managers of development agencies, railway workers and labor union activists. Interviewees were asked to look back and to explain why particular arrangements found their way into the concession agreement and conditions of loan disbursement. This let me assess the implicit and explicit assumptions that guided the key decision-makers during the concession formulation stage. Apart from that, informants were asked to evaluate the soundness of the arrangements set forth in the concession agreement on the basis of the TRL’s actual performance. Collected information was verified through repeated posing of the same – and sometimes rephrased – questions to the same informants and to the actors with differing interests. Some actors were understandably hesitant to acknowledge mistakes they made when making assumptions regarding the concession. This was countered by carefully phrased questions and verification of the answers by documented evidence. In total 36 interviews were conducted with 25 persons over the course of eight months from August 2008 until April 2009. Not all of them are cited in this paper but each one of them was valuable.

Site visits served as a source of additional information and as the means to verify responses of the interviewees. In total 23 concession-related site visits were made all along the railway line. Station masters and regional railway managers were interviewed and asked to demonstrate the workings of the enterprise. Lastly, media has been carefully monitored for concession or railway-related materials. Articles of the highest interest were scanned and used both as the basis for further data collection and as independent evidence.

Several limitations of data collection need to be highlighted. A certain degree of conflict is possible in what has to do with the researcher’s role of a consultant with the World Bank. Such confusion might make it impossible for this paper to use all the

collected data or might make the collected data biased. Also, some of the crucial actors refused to comment or insisted on anonymity. The present paper attempts to rely as little as possible on the anonymous interviews for the purposes of easier verification. Overall, repeated interviews using rephrased or modified questions were used to make the data reliable and valid and to contribute to the generalizability of the study.

Though this case study cannot be broadly generalized (Bryman, 2004: 51), it can contribute to success of the future efforts to draft, design and put through concessions in infrastructure sector, and specifically in transport sub-sector. The development actors involved in processes similar to TRC concession will benefit from the discussion of the linkages and discordances between PPP contracts and considerations external to contracts. They must, of course, contextualize findings of this research.

## **5. Analysis.**

Analysis of TRC concession follows a timeline of the process and links encountered problems between each other and to the factors that the theory predicts would be important. After a brief introduction of the TRC history of underinvestment and insolvency and a subsequent decision to divest, I will address the preparatory stage of the concession. In particular the ‘deal sweeteners’ for the concession that were provided by the World Bank, IFC and the GoT will be considered. It will be questioned whether the performance of the IFC as a sole project lender to the concessionaire was up to the requirements. I will then look at the early stages of concessions and such two key contentious issues as the labor disputes and the condition of the assets. It will be discussed how these two issues are related to such generally acknowledged causes of long-term contract renegotiation as the contract incompleteness and information asymmetry. I will then proceed to demonstrate that for a number of reasons the possibility of renegotiation and the general disintegration of partnership with this particular concession cannot be related solely to the unexpected labor disputes and condition of the assets. I go on to show that one needs to take a look at the opportunistic behavior of the parties and strategic alliances that were formed and then disintegrated. The reasons for contract disintegration are related to the multi-stage process of partnership and the difficulties of dealing with the GoT being a non-homogenous actor. I conclude by once again addressing the theoretical framework and highlighting the importance of particular causes of long-term contracts’ disintegration that are often overlooked.

### ***5.1. TRC: Underinvestment, Insolvency and Decision to Divest.***

TRC experienced underinvestment in capital assets for a large part of its history. With the break-up of East-African Community in 1977, a part of its assets remained abroad. At the same time, the railway company was expected to provide non-commercial services. Between 1979 and 1991 the tariffs were increasing at a rate lower than the inflation rate thus further exacerbating the financial health of the enterprise.

A slight increase in investment occurred in 1993 with a Railway Restructuring Project financed by the World Bank. The project activities included relaying some of the railway track that dated back to the pre-World War I era. Though this helped alleviate

the condition of the track in some critical sections of the network, the overall condition of the network remained poor. As one of the TRC managers at that time reflected, “the [railway] company was too expensive to maintain but too valuable to let go.” (Tito, 2008)

Moreover, the railway not only required significant investments but was also draining budget resources by operating at a loss. As the GoT report on the impact of privatization specifies, “over the period 1992 to 1996 the drain on TRC cash flow varied between Tshs10billion and Tshs18billion per year.” (GoT, 2005: 105) Limited fiscal space made stimulation of additional capital investment in the ailing railway company the most important task at hand. This was to be done in a way that would not put additional strain on the budget. The solution was found in the economy-wide policy move towards privatization.

TRC has been specified for divestiture in 1996, when the Government of Tanzania decided to expand its privatization program to major public utilities and infrastructure enterprises. The motivation has three related pillars. First of all, quality of services was poor while demand for them was high. Secondly, partnering with private investors was expected to increase productivity and efficiency of the enterprises. Thirdly, prices of services were high and the government aimed to decrease these. (GoT, 2005: 106) Mr. Mboma, Director General of TRC until 2008, confirmed that efficiency of the railway company in the late 1990s was limited and claimed that the enterprise was specified for divestiture primarily to cut costs. (Mboma, 2008) Mr. Tito, Chief Signals and Telecom Engineer at that time, confirmed this and also claimed that the privatization efforts were driven as much by the urge to increase productivity as by the necessity to alleviate fiscal pressure. (Tito, 2008)

In 2001 a mode of divestiture was finally specified: TRC was to be concessioned for a period of time up to 30 years. The government recognized that it needed to make an enterprise more attractive for bidders and undertook a financial restructuring of TRC amounting to about TSh 170bn (approximately USD 150m) in government expenditures and debt coverage. Nonetheless, annual loss of TSh 37bn was recorded in 2002. Moreover, Figure 10 below demonstrates that financial performance of TRC



did not become more satisfactory after 1996. The revenues increased but the operating expenses grew as well.

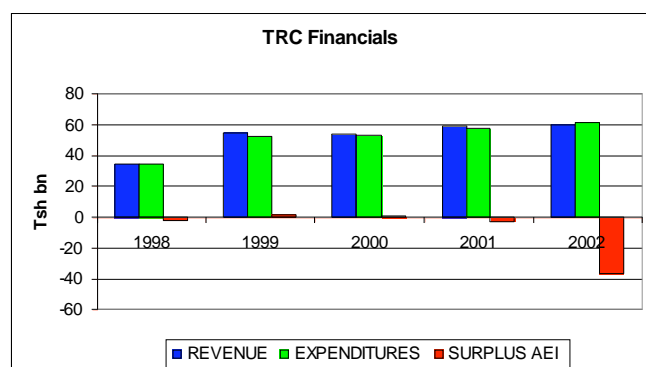


Figure 10: Financial Performance of TRC, 1998 – 2002.

Source: GoT (2005, 105)

Even though the Government of Tanzania participated actively in repairing the financial image of TRC, a completely different picture continued to prevail in the sphere of capital investments. As a number of stakeholders highlighted, specification of an enterprise for divestiture essentially cut the possibility of the Government to back capital investments. (Tito, 2008; Shamte, 2008) Though underinvestment was in line with the main privatization motivation of cost-cutting, it has been detrimental to TRC performance after 1996. Continuing lack of investment was also reflected by the increase in the incidence of major accidents from 85 in 1995 to 278 in 2000 at the time of stably low availability of rolling stock and locomotives. (GoT, 2005: 105) This has an impact on the attractiveness of the railway for freight transport businesses.

In particular, a number of stakeholders indicated that despite the fact that the demand for rail services grew rapidly after 1998, especially for the imports to the landlocked countries of the Lake Region (DRC, Rwanda, Burundi), TRC was not providing adequate service. (Dhala, 2008) Figure 11 below that the annual tonnage of freight carried by TRC grew between 1998 and 2002 to reach the levels of 1995. At the same time, according to the World Bank data, GDP growth in Tanzania and Rwanda in the end of 1990s reached approximately 6% per annum, in Burundi and Congo – about 2.0% per annum. Such growth, according to the widely used models (consider CDC, 2008: 70 for an example), would have resulted in traffic demand growth of about 15% per annum considering the low starting volumes.

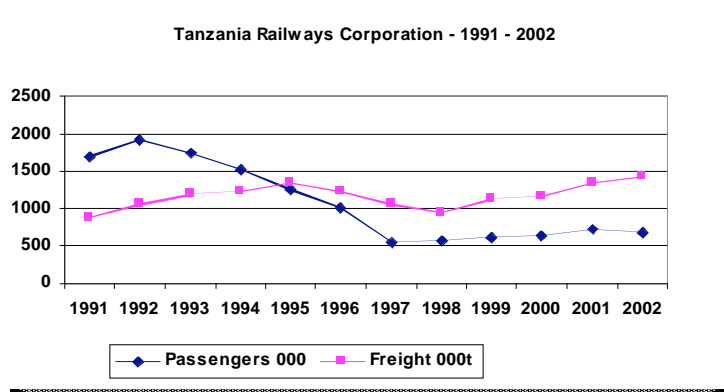


Figure 11: Tonnage performance of TRC, 1991 – 2002.

Source: GoT (2005, 106)

Overall, prior to 1996 fiscal space was insufficient to finance investments in TRC and has diminished further after that. Financial restructuring of the enterprise in 2002 somewhat sanitized TRC but did not address the key issue. An expectation, shared by TRC and the Government of Tanzania officials, was that the private sector would step in to invest in TRC and put it back on track. However, some of the government treated divestment of TRC as a part of the privatization agenda that was largely “pushed by the development partners and was not fully in the best interest of the country.” (Liamba, 2008)

## **5.2. Concession: Preparation, Tendering and the Role of IFC.**

Abovementioned financial restructuring was the first step that the Government of Tanzania took to facilitate concessioning of TRC. Request for Qualifications (RFQ) for the concession operator was issued in December 2001 and January 2002. Though several consortia signaled interest, the single bid that was received by the deadline was considered unresponsive. According to a person involved from the side of transaction advisor, the private sector was not attracted by the condition of the railway at that time. Allegedly, one of the consortia interested in bidding signaled to the Government of Tanzania that additional support needs to be extended to TRC to make it more attractive for private investors.

### **5.2.1. ‘Deal Sweeteners’ for TRC Concession.**

Several steps were taken to make the concession deal more attractive. First of all, a process of ‘change of manager’ was launched with a view to establish an entity that would serve as a landlord for railways assets. Establishment of Reli Asset Holding

Company (RAHCO) was supported by the World Bank credit to the Government of Tanzania as a part of Central Transport Corridor Project. The envisaged role of RAHCO was to oversee the stock and condition of the assets, administer investments in the railway from the side of the Government of Tanzania and to monitor the implementation of the concession agreement. Establishment of RAHCO, facilitated by the Transaction Advisor, resulted in top positions of RAHCO allocated to the former directors of TRC. Mr. Mboma, the Managing Director of TRC, was appointed the head of RAHCO and retained most of his top-level staff.

Secondly, a \$33m loan was extended by the World Bank to the Government of Tanzania who transferred it as a grant to RAHCO. The loan was to cover purchase of rail and sleepers needed for rehabilitation of the track in Itigi-Tabora section widely recognized as a bottleneck for cargo and passenger transport operations. The purchase of material was to be organized in two installments, one prior to concession agreement and one after its signing. The rationale for the World Bank credit was that the “financing of the track renewal by GoT is a prerequisite for the successful concessioning of the railway” and that the private concessionaire would not be willing to shoulder significant investments in the assets owned by the Government of Tanzania. (World Bank, 2004: 7)

Thirdly, a \$40m Partial Risk Guarantee was included in the World Bank credit to the Government of Tanzania to facilitate the concessioning of TRC by mitigating country political and policy risks. The World Bank was willing to extend this first guarantee for transport project because of its significant involvement in the transport sector and the availability of counter-guarantees from the Government of Tanzania.

These measures resulted in several developments regarding the TRC concession. First of all, seven consortia expressed interest after second RFQ. All seven were pre-qualified, four of them conditionally. This was widely perceived as a welcome indication of heightened competition for project, something highly valuable in PPP arrangements for natural monopolies where competition during the project is not feasible. (Marty and Voisin, 2008) Secondly, World Bank support to the concessioning process stimulated involvement of IFC as the sole prospective lender to the concessionaire. World Bank and IFC acted in close coordination to pursue the

agenda of putting the state-owned enterprises on the commercial track. This coordination of World Bank efforts was positively perceived by potential lenders (Jayaram, 2008) but caused more discomfort among the civil servants who treated privatization agenda with suspicion. In fact, some of these civil servants viewed this coordination as the way for the “donors to push their agenda” (Liamba, 2008). Such discontent with the role of IFIs in the process of TRC concessioning was voiced by several public officials – sometimes on the condition of anonymity – and the argument usually centered on the seeming contradiction between IFIs striving to promote private participation and competition and still using a process that yielded much less competition for project than was expected.

Indeed, despite significant interest from the consortia at the RFQ stage, only two bids were submitted at the Request for Proposals (RFP) stage. Great Lakes Railways Company Consortium led by Sheltam of South Africa submitted a bid that was deemed unresponsive as the company refused to maintain loss-making passenger service and required support from the Government of Tanzania for it. RITES of India remained the only bidder for the concession and the contract was awarded on March 6, 2006 to a consortium that included RITES of India (49.5% of equity), GAPCO (49%) and UTI Bank of India (1.5%). Overall, the bidding and selection process was less competitive than envisaged. Also, significant involvement of the World Bank and envisaged involvement of IFC caused discontent among some of the public officials who viewed IFIs as “siding in this process [concession tendering and award] with anyone but the Government.” (Anonymous, 2008) Though it is hard to precisely pinpoint the source of discontent, it might derive primarily from the opposition of some public officials to privatization efforts and market-oriented reforms in general.

### **5.2.3. IFC: Sole Lender to Concessionaire.**

IFC signaled its interest to serve as a lender to concessionaire of TRC even before the tendering process was over. A part of the World Bank Group, IFC is different from the World Bank in that it lends funds to the private companies in order to stimulate economic development and growth through the private sector. In the case of TRC concession, IFC was the sole lender and several consequences arose from this situation.

On the financial side, IFC was “not willing to finance the TRC concession company as long as GAPCO was part of consortium” since “GAPCO was in default on its payments to IFC since 2004” (IFC, 2007: 3). A condition to drop GAPCO from the concession was put forth and met no objection from the Government of Tanzania. As the result, shareholders agreement was signed between RITES of India (51% shareholder of TRL) and Government of Tanzania (49%) in May 2007, more than 15 months after the contract was awarded. Importantly, the Government of Tanzania shares of the TRL were held directly by the Treasury thus putting government in positions of a shareholder (Treasury), regulator (SUMATRA) and an asset-holding landlord (RAHCO). Additionally, the Ministry of Infrastructure Development (MOID) was to be involved in policy-making in the transport sector and coordinating efforts in all transport modes. Moreover, as a number of stakeholders indicated, “the concession agreement was not altered following the change of ownership structure.” (Tito, 2008; Shamte, 2008) Thus, there was a possibility that multiple role of the Government of Tanzania was not addressed properly in the contract.

On the side of concession preparation, the Government and concessionaire company took over some tasks that are generally viewed as being in the vicinity of the commercial project lenders. In particular, IFC, being the sole lender, could be expected to be the most objective party to evaluate the business plans and condition of the assets. In the TRC concessioning case the assets were inspected jointly by the concessionaire company (representatives of RITES) and RAHCO on April 14<sup>th</sup> 2005. Participation of the independent commercial lender in the asset due diligence could have prevented the condition of the assets from becoming a source of bitter disputes between the contracting parties. As the practice shows, risks of strategic behavior and opportunistic bidding are lowered significantly by involving commercial lenders in project preparation. (IP3, 2008) In the present case of TRC concessioning opportunities for strategic alliance-making between the Government of Tanzania and RITES of India were left open.

Indeed, trusting and partnership relations between GoT and RITES are visible from the fact that the due diligence conclusions were drawn fast and involved no substantial disputes. RAHCO was also acting as the arm of the GoT mandated to assist RITES in preparing for the concession takeover. The highest-level officials,

including President Kikwete, lauded the progress made with concession. Amicable relations were not spoiled until the concession took off.

### **5.3. Concession Launched: Disputes and Disagreements.**

Concession agreement was finally signed in September 2007 after a prolonged period following the announcement of the winning bidder. Litigation initiated by the losing consortium and a decision for the GoT to take place of GAPCO in the consortium led by RITES of India were the major events delaying the commencement of the concession. Apart from that, a loan of \$44m was extended by IFC to TRL. Commencement of concession also followed a retrenchment of approximately 4000 staff from the original 7000. According to the concession negotiations, it was the responsibility of the Government of Tanzania to provide redundancy fees to the retrenched staff while TRL took an obligation to hire the rest of the staff on the conditions not worth than those under TRC.

#### **5.3.1. Labor Disputes: First Sign of Nearing Problems.**

Concession commenced on October 1st, 2007 and already in January 2008 encountered the first problem. Tanzanian Railways Association Workers Union (TRAWU) first requested salary increase for the workers and then threatened to strike on February 27<sup>th</sup> 2008. (IPP, 2008a) TRAWU stated that the Government of Tanzania mandated a salary increase from the average monthly wage of TSh 87,000 (approximately 80 USD) to 150,000 (approximately 140 USD) and demanded TRL to follow the earlier government instructions.

Initially, TRL did not provide feedback to such demands but agreed to negotiate with the Government on the matter after the threats of strike were sounded. TRL Managing Director Jayaram held a meeting with Mr. Tito of RAHCO, Mr. Rwegasira of TRAWU and the Permanent Secretary of MOID Mr. Chambo in late March 2008 to discuss the issue. Since there was no substantial decision made, the railway workers went on to strike in April 2008. As the strike unfolded, Mr. Jayaram of TRL held a one-on-one meeting with Mr. Chambo of MOID to discuss the matter. Though the parties refused to disclose the contents of the discussion, the outcome was that the Government of Tanzania was willing to contribute approximately TSh 600mln towards the salaries but insisted on the pay rise. (Jayaram, 2008)

Overall, the TRL management underscored that the GoT is playing a dual role – both as a shareholder and as a regulator. Mr. Jayaram claimed that the labor issues were one manifestation of this. Indeed, there appears to be little communication between the Labor Commissioner’s Office in the Ministry of Labor and the MOID, let alone the TRL. The perception of TRL in early 2008, shortly after takeover, was as the “Indians who have enough money to pay good wages.” (Mdeme, 2008) Moreover, the aggrieved workers started voicing demands through the media to revoke concession contract altogether. For instance, The Guardian reported on September 4, 2008 that the leader of TRAWU “Rwegasira said the idea of terminating the contract with TRL was the right thing to do.” (IPP, 2008b) Moreover, a party-struggle dimension was added to the debate by MP Said Arfi of opposition party Chadema who claimed that “measures taken by the government to pay part of the salary of TRL shows that privatization [sic] [of] the company was useless.” (Citizen, 2008)

Complaints and concerns voiced by Chadema fell on the fertile ground of discontent of some other MPs and the bureaucracy. Indeed, Mr. Liamba of MOID criticized the actions of TRL and claimed that the government is naturally required to protect the interests of the working people even if that leads to the difficulties of a private enterprise such as TRL. (Liamba, 2008) The very fact of juxtaposing the interests of the labor and the management is, of course, not without grounds but points as much to the willingness of the government to protect the workers as to the widespread skepticism of a significant part of bureaucracy towards the private participation in former SOEs. The signs of distrust in the objectives of RITES started to appear. For instance, vocabulary used by the media changed from describing “Tanzania railways in losses” (East African Business Week, 2008) to announce that “the Government bails out the troubled railway operator” (ThisDay, 2008) and further to claim that “there is a very flawed privatization [sic] contract” (IPP, 2008c). The neutrality of the media reports was eroding and with it was the trust between the parties. The labor disputes only highlighted that divisions within the GoT were also contributing to the loss of trust.

Indeed, Liamba confirmed that he has liaised with the Ministry of Labor and TRAWU in a much more amicable way when TRC was run by his Ministry of Infrastructure Development. With this he highlighted the tight relation that existed and continues to

exist between the bureaucracy and the labor unions. He did not exclude a possibility of contract cancellation. (Liamba, 2008)

### **5.3.2. Condition of the Assets: Information Asymmetry or Strategic Alliance?**

Though threats of contract cancellation were taken seriously by TRL management, Mr. Jayaram did have a reason for refusing to shoulder increased wages. According to him, the major reason for refusing to shoulder additional wage expenses was in the poor condition of moveable assets resulting in low revenues. Essentially, Mr. Jayaram claimed that the assets that TRL took over in 2007 were not in the same condition as when examined in 2005, which impacted the business plan, and financial health of the enterprise, negatively. This is fully plausible, since, as I highlighted, the enterprise was plagued by underinvestment for a long time and especially after being specified for divestment. Two considerations are, however, important here.

Firstly, such discussion of the condition of moveable assets points once again to the importance of proper due diligence of the PPP projects. Undoubtedly, the Government of Tanzania had reasons to conceal the deterioration of the moveable assets. Possibly, the RITES of India had reasons to agree with the due diligence results even if it suspected that those could overestimate the quality of the equipment. Moreover, representatives of RITES were based in the TRC premises for nearly two years (between 2005 and 2007) and, according to Mr. Tito, “could not have not known the condition of the moveable assets.” (Tito, 2008) At the same time, TRL managers maintained that even though some of them were in Tanzania between 2005 and 2007, the condition of moveable assets was not of concern as they “expected to be able to find understanding with the Government [of Tanzania].” (Jayaram, 2008) However, it was the role of the lender to the project to conduct proper due diligence so that to estimate the bankability of the undertaking. This has not been properly done.

Secondly, a loan from IFC was supposed to be used for the TRL capital investments so that to alleviate the impact of the poor assets on the performance. The loan was not disbursed until June 2008 due to the delays with RAHCO setting up USD 2m escrow account for environmental remediation. Hence, the funds were not available for



investment and TRL needed to rely on the funds available from the shareholders. At the same time, Government of Tanzania could hardly be expected to contribute much given its motivation to ease the fiscal pressure by engaging in concession in the first place. Moreover, the members of the TRL board from the side of the Government of Tanzania were reluctant to approve the tender for rehabilitation of the locomotives by RITES claiming it was non-competitive. (IFC, 2008)

Moreover, Jayaram claimed that the poor condition of the assets damaged the performance of TRL so much that it started running deficit of operational funds. In a revised business plan released in September 2008, TRL specified the operational deficit of approximately \$83m over the course of 2009 to 2011. Though the whole business plan consisted of a single page and no further comments on how it was devised could be received, the operational deficit was becoming more and more visible. Indeed, the instances of locomotive failure nearly doubled from January 2008 to September 2008, while the condition of the track continued to dilapidate. As a consequence TRL had to revise its previous performance targets for 2008 from an estimate of about 1 million tons to be carried to 650,000 tons. It is assumed that TRL needs to carry approximately 1,5 – 1,7 million tons per annum to break even.

Argumentation of Jayaram was plausible in all respects but one. Mr. Tito claimed that representatives of RITES were working at the premises of TRC, and in close collaboration with the TRC management, between 2005 and 2007. (Tito, 2009) Therefore, the condition of the assets could not be unknown to them, especially considering the fact that they have attended workshops in Morogoro and Dar es Salaam where the actual repair works are done. According to Mr. Tito, the RITES personnel deliberately kept the problems unnoticed to negotiate alterations to the contract at some point after the takeover. (Tito, 2009) The evidence points towards a strategic alliance between the GoT and RITES in respect to the condition of the assets.

Indeed, it has been in the best interests of both parties to underestimate the extent of the problems with the assets in 2005 and to neglect their continuing dilapidation until after the takeover. Also, as the process was pulled by the Government of Tanzania, PSRC and the donor community, the bureaucracy – as skeptical towards the

concession as it was – had a little say. Predatory or opportunistic behavior of the GoT and RITES of India looks very plausible though is hard, if possible at all, to demonstrate. IFC was able to prevent it by conducting an independent due diligence but refrained from it. It is also illustrative that the base case of TRL financial performance used by IFC in its Project Appraisal Document for the \$44m load is closer to the revised business plan of TRL than to its original estimations. At the same time, in its more modest financial forecast the IFC used the same results of the due diligence of April 14<sup>th</sup> 2005 as the TRL. This shows that the early estimations of financial performance by TRL, agreed to by the GoT being one of its shareholders, were inflated and unrealistic even in relation to the overestimated condition of the assets. This once again points to the strategic alliance between the GoT and RITES of India.

#### ***5.4. Partnership in Distress.***

One core question is left unanswered by this discussion of labor disputes and strategic alliance between the GoT and RITES. The question is how did the pressure put forth by labor disputes and condition of the assets result in partnership disintegration? The answer, in my view, lies not in the contract incompleteness, information asymmetry or detrimental strategic alliance but in the relations between the different parties of the concession, some of which are non-homogenous.

##### **5.4.1. Considering Ways Out.**

Shortly after announcing the operational deficit of about \$83m, Mr. Jayaram of TRL proposed a way out of the financial distress. His suggestion was for the GoT to approach the Government of India for a soft conditions long-term loan to cover the deficit. Jayaram's vision was that the Government of Tanzania attracts the loan and transfers the funds to TRL on the no interest long-term conditions. He proposed this action in the letter to MOID in September 2008.

Mr. Liamba of MOID confirmed receiving the letter from TRL and projected that the chances of the GoT accepting such plan were small. (Liamba, 2008) His view was that the conditions proposed by TRL were unfair to the GoT in that it would have to shoulder all the risks associated with the performance of TRL without having a decisive share in the company. Though the objection is, no doubt, fair, Mr. Liamba forwarded the letter to the Ministry of Finance (after about 1 month) who are

responsible for attracting foreign loans and credits. The Ministry of Finance has not given its response or come up with an alternative plan until the present day and was not available for comments. Such deliberation on the possible ways out of financial distress points towards the role of considerations of fairness and equity in the partnership, something theory predicts as well (Ring and Van de Ven, 1994: 93-94). However, it was not the GoT as a whole that judged the fairness of Jayaram's suggestions.

Indeed, by May 2008 the matters were dealt with by the career bureaucrats of the ministries rather than politicians or politically appointed government officials. Involvement of the politicians was limited to public comments promising the restoration of the reliable and affordable transport services of TRL. An illustrative cartoon appeared in press picturing TRL as a man riding in a luxury car and asking for assistance from the government pictured as a beggar on the street. (see Appendix 3) The cartoon was lauded by a number of government officials, including those from RAHCO, and criticized by the TRL managers. Mr. Chauhdery, the Managing Director of TRL, commented that this cartoon demonstrates the hostility of some government officials towards TRL, builds on the stereotype of the Indians as being exploitative of Tanzanians and does not contribute to ending the financial distress of the company. (Chauhdery, 2009)

Publication of a cartoon like this was correlating with the demands for contract cancellation voiced by a number of officials. At a public meeting in February 2009, Mr. Tito voiced the position of RAHCO that the contract should not be renegotiated but should be cancelled altogether. His arguments were that TRL does not invest as much in the enterprise as it is supposed to according to the concession agreement. (Tito, 2009) Indeed, the agreement stipulates that the concessionaire (TRL) is obliged to invest in asset maintenance and development according to the plans outlined in the same agreement. TRL raised an objection that it was too early to judge the progress after 1 year only, since the agreement proposes 5-year plans. Mr. Chauhdery also highlighted that investing in the enterprise while being threatened with contract cancellation is counter-intuitive.

Comment by comment, the concession deal seemed more and more like a stalemate rather than a partnership. The role of the bureaucracy in contributing to such disintegration was visible and detrimental, and it was a relative autonomy of the career government bureaucrats from the officials appointed by the ruling CCM or elected to the Parliament. Propagating their views through the media, the government officials contributed to building suspicions of TRL management and essentially blocked any possible improvements to the assets or services by endangering the contract itself.

#### **5.4.2. Concession: Cancellation or Renegotiation?**

In view of the threats of contract cancellation and no response regarding the \$83m loan from India, TRL management came up with a list of changes for the concession agreement. The first one was cancellation of the concession fees for the first 5 years until 2011 (a total of about USD58m according to the revised business plan). Secondly, it requested being exempt from fuel levy of TSh200 per liter of fuel that goes to maintenance of roads, which are competing with the railway (a total of about \$4m). Thirdly, it requested that the GoT shoulders all infrastructure investments while TRL will focus on the rolling stock investment and maintenance.

While the second requirement was the only one that the GoT could plausibly agree to, the very fact of TRL voicing a possibility of contract renegotiation pointed out that concession was in a stalemate. Rather than risking having the contract cancelled, TRL went forward with proposing to alter it. The offer was initially made in November 2008 and publicly voiced in February 2009, several days before the Parliament assembled for its spring session.

The response of GoT was ambiguous and non-straightforward precisely because the politicians in the Parliament had to re-involve themselves in the process. Some MPs highlighted that the performance of TRL in 2008 was not only lower than that of TRC before the concession but also lower than the revised estimates. Indeed, in 2008 TRL only carried about 450,000 tons of freight thus endangering the solvency of the company even further and obtaining no resources for asset maintenance or development. These MPs, coming largely from the opposition parties, reiterated calls

for the contract cancellation, provided no alternative for covering the operational and capital deficits and were viewed by some as holding the populist positions.

Other MPs, including the Minister of Infrastructure Dr. Kawambwa, called for a more moderate approach, offered to investigate the viability of the loan from the Government of India and to offer TRL a trial period until the end of April 2009. These views were lauded by TRL management also present at the Parliament session and mildly criticized by some other ministry officials on the condition of anonymity.

The levels of trust to TRL management displayed by different actors in the government display how the non-homogeneity of the GoT and the role of trust for maintaining partnership at its different stages are interrelated. While there has never been an amicable attitude from the bureaucrats to the concession deal, the GoT led by CCM retained its trust and voiced it even after delegating the day-to-day decision-making to the lower levels. The most recent events point to that the top echelons of the CCM and GoT are regaining control over the process.

On April 16<sup>th</sup>, the GoT publicly recognized for the first time that it is a part of TRL and, thus, has to share in the concession fees. At the same time, it claimed that it is necessary to renegotiate the contract. (Citizen, 2009) Minister Kawambwa confirmed the on-going talks with India about attracting \$83m to cover the operational deficit. The World Bank also remains willing to extend a loan to finance further capital investments if the operational deficit is bridged. IFC is confirming its willingness to unfreeze the remaining \$37m for capital investments once the shareholders' negotiations of the concession deal start. The question that still remains is which approach will prevail – will there be a contract cancellation with RITES being blasted in the media for all wrongdoings unquestionable and disputable or will there be an amicable revision and renegotiation of the contract between the parties that can rebuild trust? This remains to be seen and all parties involved will have a stake at determining whether the partnership disintegrates beyond the current, already, less than perfect state of unity.

### **5.5. Concluding Remarks.**

Discussion of the concession deal development points to a number of theoretical conclusions. It appears that the contract was incomplete, as manifested by the labor disputes. An increase of wages was neither envisaged nor guarded against in the contractual arrangement. The fact that this incompleteness was overlooked can be related to the significant levels of trust existing between the contracting parties, as the theory predicts. (Segal, 1999: 74) Significant trust is confirmed by the way the contracting parties conducted the assessment of the condition of the assets. The speed and ease, with which the faulty conclusions overestimating the quality and quantity of the assets were drawn, demonstrate that the contracting parties engaged in a strategic alliance. Likelihood of such alliances was also predicted by prior research. (Trujillo, Quinet and Estache, 2002: 329) Accordingly, no signs of information asymmetry and related opportunistic behavior were uncovered. Therefore, the first hypothesis is not confirmed and explanation of the disintegration of a concession contract should go beyond the effects of incomplete and asymmetric information.

Detailed review of the behavior of the contracting parties highlighted that the public actor of the PPP deal is not homogenous. Tanzanian bureaucracy got in charge of the concession deal at its initial stages and displayed much less willingness to coordinate efforts with the private party than the political leadership. As the role of the bureaucracy is better understood through the prism of political history and political transformation of Tanzania and, thus, points towards the importance of trust in a particular context for the viability of a contractual arrangement. Moreover, dynamics of trust holds a significant explanatory power, as it was the erosion of trust that led to disintegration of a strategic alliance around the condition of the assets and to the detrimental effects of the incompleteness of the contract regarding the adjustment of wages. Accordingly, the second hypothesis is confirmed by the analysis.

Overall, contribution of this paper is that the role of the often-overlooked factors of contract disintegration is highlighted and demonstrated through empirical research. Discussions of the role of trust in relation to information incompleteness and asymmetry, as well as to the viability of strategic alliances, are lacking, especially in empirical research. Moreover, analyses of PPP deals focused on particular causes of

their failure, while this paper ties many causes together and shows links between them.

Undoubtedly, the research can be taken forward by addressing various openings. For instance, the role of the donor community can receive greater attention from outside researchers – something not particularly feasible in relation to this paper. Moreover, relations of trust should be subjected to a more thorough and critical analysis since some of the instances of fruitful informal communication lack needed transparency and raise suspicions across the board of stakeholders. Lastly, crucial role of effective and independent economic regulation has been highlighted in other studies but remained beyond the scope of this paper.

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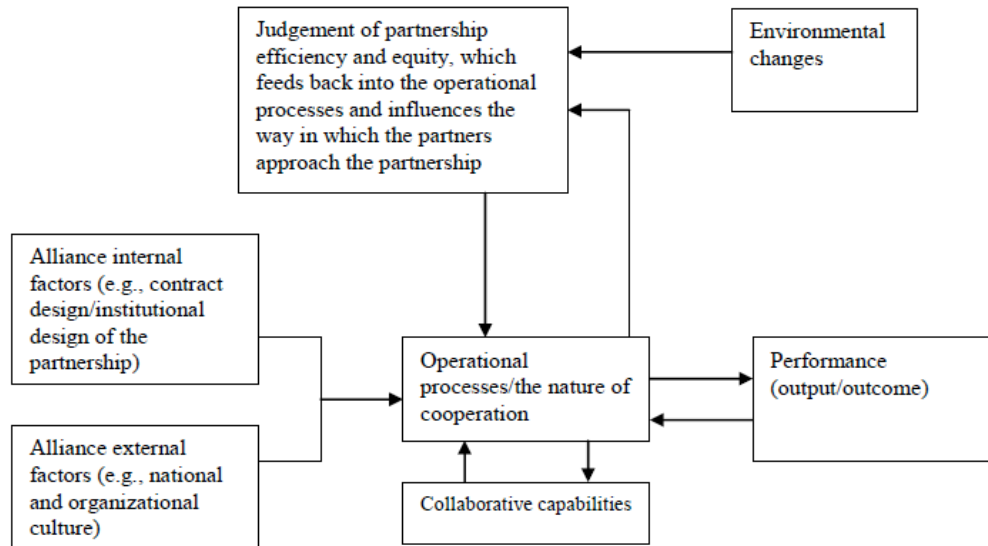
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## Appendix 2: Contractual and Relational Factors of Partnership Success.

Figure 3 Conceptual Framework



\*the model draws upon the work of Doz 1996, Ring and van de Ven 1994, and Ariño and de la Torre 1998

Source: Weihe, 2006: 27 (Figure 3)

### Appendix 3: Railway Concession (A Caricature).



Source: SundayCitizen, January 18, 2009.



