Available online at www.sciencedirect.com
ScienceDirect
Journal of Purchasing & Supply Management 14 (2008) 43–54
JOURNAL OF PURCHASING AND SUPPLY MANAGEMENT
www.elsevier.com/locate/pursup

The dynamics of contractual and relational governance: Evidence from long-term public–private procurement arrangements

Jurong Zheng*, Jens K. Roehrich[1], Michael A. Lewis[2]

Centre for Research in Strategic Purchasing and Supply, School of Management, University of Bath, Claverton Down, Bath BA2 7AY, UK

Received 8 August 2007; received in revised form 22 January 2008; accepted 24 January 2008

Abstract

This paper investigates the detail and dynamics of how contractual and relational governance mechanisms are deployed in managing complex, long-term public–private supply arrangements. Using empirical data from two UK Private Finance Initiative (PFI) cases, the paper analyses the interplay of governance mechanisms along a timeline of project phases. Conceptual and practical findings confirm that relational and contractual mechanisms are indeed complementary forms of exchange governance but also that the relational intentions of all parties frame whether the contract is interpreted as a written sign of distrust or commitment. Equally, relational and contractual governance follow different development paths: both follow cumulative trajectories but (a) inter-personal relational mechanisms are more incremental and fragile, whereas (b) contractual mechanisms move with fewer degrees of freedom and 'anchor' the exchange throughout the life cycle. Finally, the different development characteristics of relational and contractual mechanisms mean that their dynamic interplay does not follow consistent patterns. The paper concludes with suggestions for more longitudinal studies.

Keywords: Public–private partnership; Long-term relationship; Contractual and relational governance

1. Introduction

This paper contributes to a debate about the dynamics of inter-organisational governance. It explores the detail of *contractual* and *relational* governance mechanisms and their changing significance over time through an investigation of the management of long-term arrangements between public buyers and private service providers. Previous studies have suggested that contractual and relational governance need to be considered as complementary mechanisms (Ferguson et al., 2005; Poppo and Zenger, 2002) but very little work has explored the details and dynamics of this interplay (Klein Woolthuis et al., 2005). Specifically, this paper aims to develop a richer understanding of the detailed composition of these mechanisms and their contingent interplay over the life of an exchange relationship. This will contribute to better aggregate conceptualisation and theory building and generate more meaningful practical guidance.

In order to access the phenomena two long-term supply arrangements have been investigated; both are UK Private Finance Initiative (PFI) design-build-finance-operate contracts with a 25- and 30-year lifespan, respectively. A key consideration in selecting PFI arrangements as the empirical focus of the research was the opportunity this provided to review specific supply arrangements over an extended period of time. In other words, the buyer–supplier 'lock-in' inherent in public–private partnership (PPP)/PFI actually makes it particularly useful for exploring exchange dynamics. The next section presents the conceptual background to different contractual and relational governance mechanisms and their interplay over time. Additionally, the specific governance challenges of public–private relationships are reviewed. The third and fourth sections describe the methodology and case findings. The final section presents the main conclusions and implications for future research.

*Corresponding author. Tel.: +44 1225 386512.
E-mail addresses: j.zheng@bath.ac.uk (J. Zheng), j.roehrich@bath.ac.uk (J.K. Roehrich), m.a.lewis@bath.ac.uk (M.A. Lewis).
[1]Tel.: +44 1225 383761.
[2]Tel.: +44 1225 386536.

1478-4092/$ - see front matter
doi:10.1016/j.pursup.2008.01.004

2. Conceptual background

This section draws upon a range of literature to explore relational and contractual governance as both discrete and complementary constructs. Additionally, the section summarises some of the key literature on PPP/PFI procurement arrangements, especially where this research touches upon the paper's core conceptual concerns.

2.1. Contractual governance

Arguably the dominant theoretical logic for explaining inter-organisational exchange is the Transaction Cost Economics (TCE) perspective. Assuming opportunism and bounded rationality (Rindfleisch and Heide, 1997), TCE asserts that firms attempt to minimise transaction costs by 'assigning transactions (which differ in their attributes) to governance structures (the adaptive capacities and associated costs of which differ) in a discriminating way' (Williamson, 1985, p. 18). As a result, organisations only internalise activities where adverse costs might arise from operational difficulties in a market exchange, primarily driven by uncertainty, frequency of exchange, and asset specificity.[3] Furthermore, TCE argues that parties have to safeguard against the hazard of opportunism by applying legal contracts, specifying what is acceptable and what is not, with threats of legal enforcement or non-legal retribution (Williamson, 1975).

'Classical' contract theory assumes that complete contracts can be drafted (Lyons and Metha, 1997), that is containing *all* the necessary safeguards to mitigate opportunistic behaviour and reduce transactional ambiguity by clear specification of what is and what is not allowed within a relationship (Lui and Ngo, 2004). For example, increasing the risks associated with opportunistic behaviour by stipulating penalties that change the pay-off structure (Parkhe, 1993). Conceptually close to TCE, an optimal contract means one with the lowest transaction costs relative to outcome.

In practice however, drafting costs and asymmetric information render most contracts 'incomplete'. Equally, contracting can only define remedies for foreseeable contingencies and/or at best specify processes for resolving unforeseeable outcomes (Poppo and Zenger, 2002). Incomplete contracts contain non-legally enforceable and/or poorly specified intentions, promises, and conditions that may easily by misinterpreted by the courts (Deakin and Wilkinson, 1998). Consequently, an incomplete contract is defined '*as an agreement that goes beyond what is verifiable*' (Chen, 2000, p. 211). Interestingly, although incomplete contracts inevitably offer less certainty (i.e. fewer legal safeguards) for the contracting parties, non 'legally enforceable' elements of an incomplete contract can still provide elements of formal control, by indicating limits of acceptability. Moreover, because gaps in an incomplete contract are only filled as contingencies arise, they can actually underpin greater flexibility in the execution of a supply agreement (Klein Woolthuis et al., 2005).

Contracts are central to most supply arrangements: providing a legally bound, institutional framework in which each party's rights, duties, and responsibilities are codified; and goals, policies and strategies underlying the relationship are specified. Although emphasis is normally placed on the prevention of inappropriate agent behaviour (e.g. opportunism), these formal agreements can facilitate effective exchange (Carson et al., 2006; Luo, 2002).

2.2. Relational governance

Although TCE may provide the dominant *economic* logic for determining organisational scope, more managerial research typically applies a 'relational' logic to supply arrangements. Indeed such an approach is often positioned as being distinct from the 'impersonal, discrete and short-term' transaction-based approach. Contracts have been presented as a manifestation of power that can be effective in certain circumstances, but more often promote conflict (Gaski, 1984) and defensive behaviour (Hirschman, 1984). The relational perspective emphasises the role of trust in achieving mutually successful supply outcomes. The industrial network model developed by the Industrial Marketing and Purchasing (IMP) group (Håkansson and Snehota, 1995) for example suggests that inter-organisational relationships develop when two companies build up activity links, resource ties, and actor bonds. Relational governance mechanisms therefore, based upon social processes, like trust, that promote norms of flexibility, solidarity and information exchange, can safeguard, albeit informally, against exchange hazards and facilitate the enforcement of obligations (Baker et al., 2002; Granovetter, 1973, 1985; Gulati, 1995; Ring and Van de Ven, 1994). Similarly, unforeseeable contingencies may be accommodated by a bilateral approach to problem solving which facilitates adaptations—especially within a long-term relationship (Zand, 1972). A variety of enforcement mechanisms such as the expectation of repeat business, reputation effects, social obligations, and fulfilment of basic social needs are likely to encourage exchange-specific investments (Poppo and Zenger, 2002) and support the use of relational governance (Zhou and Poppo, 2006). Conversely, Larson (1992) highlights that the development and maintenance of relational governance, including a network of social ties, may be time and resource consuming. Intensive social ties may restrict companies from acquiring information and spotting new opportunities outside their networks (Uzzi, 1997). Equally, as scale and scope of exchange increases, exchanges are simply harder to maintain and sanction through long-standing ties because repeat business and cultural homogeneity are less likely (North, 1990).

[3]An asset is transaction specific if its value in a transaction with another party is reduced and correspondingly, the larger the value 'gap' between its best and best-alternative use, the greater the specificity of the asset.